S. Hrg. 100-7

STRENGTHENING THE SAFETY AND SOUNDNESS OF THE FINANCIAL SERVICES INDUSTRY

HEARINGS

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

BANKING LEGISLATION FROM THE 99TH CONGRESS INCLUDING FSLIC RECAPITALIZATION, EMERGENCY BANK ACQUISITIONS, NONBANK BANKS, SECURITIES POWERS FOR BANK HOLDING COMPANIES, AND BANK CHECK HOLDS

JANUARY 21, 22, AND 23, 1987

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STRENGTHENING THE SAFETY AND SOUNDNESS OF THE FINANCIAL SERVICES INDUSTRY

WEDNESDAY, JANUARY 21, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:30 a.m. in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Cranston, Riegle, Dodd, Dixon, Sasser, Sanford, Shelby, Graham, Heinz, D'Amato, Hecht, and Gramm.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

First, I want to apologize for being tardy. Jake Garn, the former chairman, made a point of being here on time and did a marvelous job throughout the years. I am chagrined that I have to start off 14 minutes late, but we had to appeal for our budget before the Rules Committee—and, of course, without the budget we couldn't function at all.

I'm going to announce a different procedure this morning and I apologize to Chairman Volcker and the other witnesses for not telling them in advance.

I'm going to see if we can follow a policy of having the oral presentation confined to 10 minutes. At the end of the questioning, if we haven't adequately covered any part, we will give the witness 2 minutes to add anything he would like to add to supplement what he has said.

The reason I'm doing this is that I went through the statements last night and I found we would be here for 3 hours listening to statements before any questions would be asked, and I think that would be a mistake. We also have witnesses who are extraordinarily agile intellectually and I'm sure that they can handle this like a piece of cake.

This is the committee's first hearing of 1987. But the issues we face aren't new at all. We've been over them repeatedly since 1983.

In 1983-84 the committee held 23 days of hearings on granting new powers to depository institutions and closing the nonbank bank loophole. Under Chairman Garn's leadership, the committee reported a comprehensive banking bill which passed the Senate on September 18, 1984, by a vote of 89 to 5.

In 1985-86, the committee held 11 days of hearings on comprehensive reform in the financial services industry, and 8 days of hearings on deposit insurance reform. The committee reported and the Senate passed a bill recapitalizing the Federal Savings and Loan Insurance Corporation and granting regulatory agencies new powers to deal with failed and failing institutions.

The Subcommittee on Consumer Affairs also held hearings on check holds, and the Senate passed a consumer check hold bill in 1986 similar to the one contained in the comprehensive banking bill passed in 1984. So we have been over this ground before. Now it's time to act.

We live in a world in which there is tremendous uncertainty and confusion in the structure of our financial system. Just a few years ago, it was relatively clear who did what. Banks made loans and offered checking accounts; securities brokers sold securities; realtors sold homes; insurance agents sold insurance, and savings and loan associations made mortgage loans.

Today, all of those distinctions are blurred. You can hardly pick up the newspaper without reading about another insurance company that has bought a bank or another bank that has gone into the securities business. Firms such as Sears, American Express, and Merrill Lynch are beginning to construct financial services empires that claim to deliver all financial services to the consumer under one roof. New financial products appear almost daily in bewildering complexity.

There are those who applaud these developments and say we should remove any remaining legal barriers to the consolidation of financial services. Others, including the Chairman of the Federal Reserve Board, are more cautious. They believe that banks have a unique role in our economy and that we should seek to preserve the distinction between banking and other types of financial and commercial endeavors. I include myself in this latter group.

Most of the present uncertainty in our financial structure centers on legal issues under the Glass-Steagall Act, which separates commercial banking from investment banking, and the Bank Holding Company Act, which requires that the activities of bank holding companies be closely related to banking. The central purpose of those two statutes is to maintain a separation between banking and other kinds of financial and commercial activity. The bank attorneys have used their ingenuity to find and exploit loopholes in those statutes—gaping loopholes that, unless closed, will soon result in the de facto repeal of those statutes. These efforts have often been aided and abetted by sympathetic bank regulators eager to impose their own policy views on laws passed by the Congress.

In many ways the question of whether we should have more deregulation or less deregulation is no longer the most important issue on the table. What has become the most important issue is who is going to decide. Will our financial system continue to be shaped by the lawyers, the bank regulators, and the courts in a haphazard fashion, or will the Congress do the job for which it was elected?

Some have asked, how can the Congress even consider the possibility of a pay raise when it has consistently ducked making the hard decisions expected of it by the voters? That is a good question.

I share the sense of frustration faced by Senator Garn over the last 4 years in trying to get the Congress to make a decision. We have arrived at the point where we have no responsible alternative but to act and act promptly. If it is the will of the Congress to repeal the Bank Holding Company Act and the Glass-Steagall Act, then let's get on with the job and do it. But if we still believe in the policies embodied in those laws, then let us act to close the loopholes that threaten their very foundation.

Whatever the case, let us decide and decide promptly. I plan to call a meeting of the committee in late February to consider all of the unresolved issues that are the subject of these hearings. I urge my colleagues to prepare themselves for making decisions. If we don't do our job, others will, and we will inevitably lose our relevance as the elected representatives of the people.

Senator Heinz, do you have an opening statement?

Senator HEINZ. Yes, Mr. Chairman, but Senator D'Amato was here before I was.

The CHAIRMAN. Go ahead, Senator D'Amato. That is the rule we've established in the committee and we will speak by appearance.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, of course, I am pleased to welcome our distinguished panel of witnesses and Chairman Volcker. I am quite anxious to hear his comments on where we should be going.

Mr. Chairman, I am not going to read my full statement but I am going to say that I do doubt the resolution of some of the issues that we have been wrestling with, particularly the grant of new powers to commercial banks and the closing of the nonbank bank issue, that these issues will be resolved in a short period of time.

Therefore, I would urge the chairman and my colleagues to move swiftly and enact that legislation that demands our most immediate attention. We have four new members on this committee. These issues are complex and there is a division of opinion with respect to them. The people on this committee know my opinion with respect to expanded bank powers.

However, having said that, every day we fail to act to recapitalize the FSLIC system we are indeed flirting with a real catastrophe, with a real danger, and I see there's no reason for us not to pass that FSLIC recapitalization bill immediately and then get on with the business of having full hearings. If we come to an expeditious vote, whichever way it goes, so be it, but I really do think, Mr. Chairman, that the interest of the entire financial community would best be served by moving on that recapitalization.

[The complete prepared statement follows:]

STATEMENT OF THE HONORABLE ALFONSE M. D'AMATO
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
JANUARY 21, 1987

I WOULD LIKE TO WELCOME OUR DISTINGUISHED PANEL OF WITNESSES TO THIS COMMITTEE'S INITIAL HEARING OF THE 100TH CONGRESS. THE IMPORTANCE OF THIS HEARING DOES NOT LIE IN THE FACT THAT IT IS THE FIRST OF THE NEW CONGRESS, RATHER THE IMPORTANCE LIES IN THE SUBJECT MATTER THAT WE WILL ADDRESS THIS MORNING AND IN THE SUBSEQUENT TWO DAYS.

ALTHOUGH CHAIRMAN PROXMIRE HAS SET AN AMBITIOUS AGENDA FOR THE COMMITTEE, I BELIEVE THAT THE COMMITTEE MUST SET SOME REALISTIC PRIORITIES IN EXAMINING THESE ISSUES. INITIALLY THE COMMITTEE SHOULD ADDRESS AND SEEK THE SWIFT ENACTMENT OF THOSE LEGISLATIVE PROPOSALS THAT PASSED THE SENATE IN THE WANING DAYS OF THE 99TH CONGRESS. AMONG THE LEGISLATIVE PROPOSALS WHICH SHOULD BE ON THE FAST TRACK ARE: (1) THE PLAN TO RECAPITALIZE THE FSLIC FUND; (2) THE PROPOSAL ADVANCED BY THE COMPTROLLER, THE FDIC AND THE TREASURY DEPARTMENT FOR NEW POWERS TO DEAL WITH FAILING AND FAILED BANKS; AND (3) THE NEED FOR LEGISLATION TO DEAL WITH CHECK-HOLDING PRACTICES OF FINANCIAL INSTITUTIONS.

ALTHOUGH CHAIRMAN PROXMIRE HAS SUGGESTED HIS DESIRE TO MOVE MORE QUICKLY ON A BROADER LEGISLATIVE PACKAGE, I BELIEVE HE SHOULD FOLLOW THE UNSELFISH EXAMPLE OF CHAIRMAN GARN WHO PLACED THE PRIORITY OF THE SAFETY AND SOUNDNESS OF THE BANKING SYSTEM ABOVE HIS PERSONAL AGENDA DURING THE LAST CONGRESS. IN SEEKING THE PASSAGE OF LEGISLATION THAT DEMANDED IMMEDIATE ATTENTION, CHAIRMAN GARN DID EVERYTHING IN HIS POWER TO ACCOMMODATE THE NEEDS OF HIS COLLEAGUES IN THIS COMMITTEE AND IN THE REST OF THE SENATE.

SINCE THE END OF THE 99TH CONGRESS, NOT MUCH HAS CHANGED. MANY OF THE ISSUES TO BE ADDRESSED BY THE COMMITTEE IN THE NEXT THREE DAYS ARE VERY CONTROVERSIAL. I DOUBT THE RESOLUTION OF ISSUES SUCH AS THE GRANT OF NEW POWERS TO COMMERCIAL BANKS AND THE CLOSING OF THE NON-BANK BANK ISSUE WILL BE ACCOMPLISHED IN THE SHORT TERM. THEREFORE, I WOULD URGE THE CHAIRMAN AND MY COLLEAGUES TO MOVE SWIFTLY AND ENACT THE LEGISLATION THAT DEMANDS OUR MOST IMMEDIATE ATTENTION. FOR EXAMPLE, EVERYDAY THAT WE FAIL TO RECAPITALIZE THE FSLIC FUND EXACERBATES AN ALREADY SEVERE PROBLEM. OF ALL THE LEGISLATIVE PROPOSALS BEFORE THIS COMMITTEE, THE RECAPITALIZATION OF THE FSLIC IS THE ONE THAT HAS THE MOST IMMEDIATE IMPACT UPON PUBLIC CONFIDENCE IN OUR FINANCIAL SYSTEM. A FAILURE TO ACT EXPEDITIOUSLY ON SOME FORM OF A RECAPITALIZATION PLAN IS SHEER FOLLY.

MY POSITIONS ON THE OTHER ISSUES BEFORE THIS COMMITTEE ARE WELL KNOWN BY NOW. I NEED NOT ELABORATE UPON THEM NOW OTHER THAN TO SAY THAT WE HAVE 4 NEW MEMBERS TO THE COMMITTEE AND ONE RETURNING MEMBER WHO SHOULD BE EXTENDED THE CONSIDERATION AND COURTESY OF A FULL EXAMINATION OF THESE ISSUES. I LOOK FORWARD TO WORKING WITH THESE NEW MEMBERS, THE CHAIRMAN AND MY OTHER COLLEAGUES IN THE COMING MONTHS.

The CHAIRMAN. Thank you, Senator D'Amato.
Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I am delighted to see our distinguished friend, Chairman Volcker, here today. I have a statement which I have already given the reporter which I ask be reproduced in the record in full, Mr. Chairman.

I just want to make this comment. I have said a number of times publicly and sometimes in this committee on occasion when we've considered these matters that I think it's a mistake to try to do everything in one omnibus bill. I hope the committee will consider whether all these matters aren't sufficiently important that we ought to look at each of them as separate issues on a separate basis, Mr. Chairman.

Now my distinguished friend, the former chairman of the committee, for whom I have the utmost respect, and I have differed on that in meetings where we have both addressed groups. I think that our chances of ultimately getting a bill through the House and through the conference process for a very large omnibus bill are very small, Mr. Chairman. So I would like to indicate publicly at the beginning that I think we ought to look at all these issues separately rather than having one large omnibus bill. But of course I respect the judgment of the chair on that and would love to hear from him in time in a committee meeting about what his intentions are.

Again, I have a statement there, Mr. Chairman, and I am delighted to be here for this hearing.

[The complete prepared statement follows:]

JANUARY 22, 1987

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE

OVERSIGHT HEARINGS
ON
BANKING LEGISLATION

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE BANKING COMMITTEE CONTINUES IT OVERSIGHT HEARINGS ON BANKING ISSUES THAT HAVE CARRIED OVER FROM THE 99TH CONGRESS. WE HAVE A DISTINGUISHED GROUP OF WITNESSES BEFORE THE COMMITTEE TODAY REPRESENTING STATE GOVERNMENTS, THE THRIFT INDUSTRY, AND THE BANKING INDUSTRY. I LOOK FORWARD TO HEARING THEIR TESTIMONY.

AS I STATED YESTERDAY, I BELIEVE THE COMMITTEE SHOULD ATTEMPT TO ACT QUICKLY ON THE ALL THE ISSUES WE FAILED TO RESOLVE IN THE LAST CONGRESS. WE MUST ACT ON FSLIC RECAPITALIZATION, ON THE

ISSUES ADDRESSED BY THE SO-CALLED "REGULATORS" BILL, ON THE NONBANK BANK AND SOUTH DAKOTA LOOPHOLE QUESTIONS, AND ON EXPANSION OF BANK ASSET POWERS. IT WOULD ALSO BE DESIRABLE TO REACH AN EARLY CONSENSUS ON THE CHECK-HOLD ISSUE.

I AM NOT CONVINCED, HOWEVER, THAT THE BEST WAY TO ACHIEVE ENACTMENT OF LEGISLATION IN EACH OF THESE ISSUE AREAS IS TO COMBINE THEM INTO A SINGLE, OMNIBUS BILL. WE HAVE TRIED THAT IN EACH OF THE LAST TWO CONGRESSES, AND THE RESULT HAS BEEN THAT WE HAVE NOT MADE ANY PROGRESS ON ANY OF THESE ISSUES.

I AM PARTICULARLY CONCERNED ABOUT THE FSLIC ISSUE. I DO NOT THINK WE CAN AFFORD TO DELAY ACTION ON RECAPITALIZATION ANY LONGER. I BELIEVE CONGRESS MADE A REAL MISTAKE BY NOT ENACTING LEGISLATION IN THIS AREA LAST YEAR. I UNDERSTAND THAT THERE ARE SOME DIFFERENCES OF OPINION ON HOW BEST TO HANDLE THE RECAPITALIZATION, AND I BELIEVE THE COMMITTEE SHOULD CONSIDER ALL ALTERNATIVES VERY CAREFULLY. THE BOTTOM LINE, HOWEVER, IS THAT WE MUST ENACT RECAPITALIZATION LEGISLATION BEFORE SUMMER. FRANKLY, I'M NOT SURE WE CAN AFFORD TO WAIT THAT LONG.

FURTHER, IT IS WORTH KEEPING IN MIND THAT THE JURISDICTIONAL SITUATION IN THE HOUSE IS MORE COMPLICATED THAN IT IS IN THE SENATE. BANK ASSET POWERS, FOR EXAMPLE, WILL LIKELY HAVE TO BE CONSIDERED BY TWO HOUSE COMMITTEES, ENERGY AND COMMERCE, AND BANKING. THIS WILL INEVITABLY LEAD TO SOME DELAY.

I BELIEVE WE SHOULD CRAFT LEGISLATION IN A WAY THAT WILL MAXIMIZE THE CHANCES OF SUCCESS. HOWEVER, I HOPE WE WILL NOT CREATE A LEGISLATIVE "HOSTAGE" SITUATION THAT WILL MAKE IT MORE DIFFICULT TO MAKE PROGRESS IN THOSE AREAS WHERE WE CAN MAKE PROGRESS.

I THINK THIS COMMITTEE SHOULD PRESS HARD FOR ACTION ON THE ENTIRE FINANCIAL SERVICES AGENDA, BUT WE MUST BE PRACTICAL ENOUGH TO SEIZE THE OPPORTUNITIES TO ACHIEVE AT LEAST PARTIAL SUCCESSES. THE ALTERNATIVE IS TO RISK A THIRD CONGRESS WITH NO MEASURABLE PROGRESS ON ANY OF THE MAJOR ISSUES FACING US.

The CHAIRMAN. Thank you, Senator Dixon.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you. First, let me join in welcoming our witnesses. I will make a very brief observation.

We will undoubtedly debate at some length whether or not we should have one or several bills. We will have a variety of criteria for judging what the content of that legislation may be—benefits to the consumer, the safety and soundness of the Nation's payment system, the competitiveness of U.S. financial markets, the benefits to overall U.S. economic growth and competitiveness of our economy generally—but it is this Senator's view that it is timely and essential for Congress to take action on these issues.

We should not let the States or the markets preempt the judgments that we, as part of our responsibility, should be making. It is coming close to the point where the system is beginning to run amuck and the financial framework within which people are supposed to be operating is beginning to look like Swiss cheese. We have a responsibility to give shape to both the regulation of the institutions and the markets, and to decide to what extent there should be further changes in the freedom or maintaining current restrictions in these markets.

I hope, Mr. Chairman, we will make those judgments even if they are not part of a package.

[The complete prepared statement follows:]

STATEMENT OF SENATOR JOHN HEINZ

Mr. CHAIRMAN. I'd like to welcome our distinguished witnesses—Chairman Volcker, under Secretary Gould, and Messrs. Clarke, Seidman and Gray—who will be testifying before the Committee today.

More importantly, Mr. Chairman, you are to be commended for setting the pace on the fast track with these hearings. During the past 4 years, we have run more than a few laps in the race to improve the legislative framework governing the Nation's financial system. But the time is right to complete the marathon.

Now, more than ever, is the time for Congress—not the States, not the regulators, not the courts but Congress—to determine the legal and regulatory framework which will govern the financial marketplace. The system may not be broken, but it has run amok. Suffice it to say that the present arrangements are in disarray. Quite frankly, too much time, money and resources are being wasted by the players in devising complex schemes to circumvent—indeed, make Swiss cheese out of—the system which could be more profitably employed in delivering financial services to the public.

Mr. Chairman, the task is urgent and the timing is critical. The FSLIC crisis is moving inexorably to a head; the economy has wreaked havoc on our agricultural and energy banks; and events are forcing change that may, or may not be consistent with considered judgments about the public interest.

We still have the opportunity to shape the direction of the financial system in a manner that accommodates the changes in the market but also recognizes the concerns of public policy: competition, consumer benefits, a safe and sound banking system and economic stability.

Mr. Chairman, I congratulate you on your prompt action in furthering these aims through this series of hearings. I look forward to cooperating with you in working toward that end.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I have a statement that I will submit for the record, but I want to commend you, Mr. Chairman, for calling these oversight hearings and I look forward to the testimony of Chairman Volcker and other distinguished witnesses here because, as you know and most of the people here know very well, the clarification role of what are financial institutions and the role that they are going to play in the future and the soundness of our system go to the very heart of this country and its economic system and we've got a lot of work in here and I believe you as the chairman will lead us in that role.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. Chairman: I want to commend the Chairman for calling these series of oversight hearings today.

I am pleased to be here and to have the opportunity to hear from the distinguished Chairman of the Federal Reserve Board, the FDIC and the Federal Home Loan Bank Board; the distinguished Undersecretary of the Treasury and the distinguished Comptroller of the Currency.

As a new member of the committee, I look forward in joining my distinguished colleagues on the committee in clarifying the various roles of the players in the financial services industry in order to foster the ongoing safety and soundness of our financial system.

Today we are in a state of turmoil. It is obvious that the basic legal framework established by the Congress 50 years ago has been left in the dust by rapid technological innovations and changed market conditions.

Piecemeal judicial and administrative decisions are forcing our financial system to evolve in a haphazard and dangerous way. This undirected evolutionary process could result in unwanted mutations threatening the entire financial order. Prudence dictates that we must begin to legislatively establish a more stable framework.

In fashioning this system, several concerns come to mind.

First, we must approach this reform with an eye to the future so that the establishement of new practices is not at the cost of long-term safety and soundness.

We must consider our actions in the context of their impact on the smaller community banks in rural areas, the consumer and the economy as a whole.

Of particular importance to me is the ability of our financial institutions to compete in the world marketplace.

Again, I commend the Chairman and Senator Garn for their leadership on these complex and difficult issues. I look forward to working with you, with the other members of the committee, with the witnesses and all those interested in addressing the problems facing the financial services industry. I thank the witnesses for their willingness to provide us with the benefit of their experience and their recommendations for legislative action.

The **CHAIRMAN**. Thank you very much, Senator Shelby.
Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **GRAMM**. Mr. Chairman, I would like to begin by congratulating you on your statement and say that I am in full agreement with it.

I think what we face today is a situation where there is little relationship between the regulatory process currently in effect and the realities of the marketplace. The distinction among financial institutions is blurred, whether we like it or not. In fact, in the past I have opposed regulations and legislation that have blurred these distinctions, but I think the distinctions are blurred and they are probably blurred permanently.

I think it is important for us to develop a regulatory system that fits the realities of the marketplace, and I think that if we sit around and wait for the different financial institutions to come up with something they agree on, then we are going to wait forever.

So I strongly believe that we ought to move ahead with a comprehensive reform of the regulatory system. I think we ought to look at the realities of the marketplace and regulate financial institutions based on factors such as the liquidity of their liabilities. I think we ought to regulate them not on the basis of the kind of charter they have. Many banks today don't have charters because they are not formally in the banking business, though they are doing all the things we all learned in the money and banking textbook that banks do.

So I think it's very important that we look at the regulatory system, that it be comprehensively reviewed. I doubt quite frankly that we can legislate on each particular part separately. I think the only hope we have of putting together a bill that will bring bank regulation into the 1980's and 1990's is to do it jointly, to bring the legislation before the committee, to allow every member to make their argument, and then to move ahead with a system that's aimed at promoting efficiency in the financial markets of the country and aimed at making us competitive in selling world financial services and aimed at dealing with the problems that we know exist in the financial structure of the country.

And I commend you for your opening statement, and I strongly support it.

The **CHAIRMAN**. Thank you very much, Senator Gramm.
Senator Sanford.

OPENING STATEMENT OF SENATOR SANFORD

Senator **SANFORD**. Thank you, Mr. Chairman, well, I may not get another chance to say this, so I will take this opportunity to thank Chairman Volcker for his statesmanlike leadership over the years and express the hope that he will be with us in this position for a long, long time.

Second, I identify with what the chairman said and what Senator Gramm had to say. I think we do indeed need to get at all of these problems and get at them as quickly as possible. The only word of caution that I would suggest, because I've had just a slightly uneasy feeling that we're moving so rapidly, I think we need to move deliberately and I think we need to move across the board as you suggest, but I hope we don't attempt to rush into decisions.

The CHAIRMAN. Thank you very much, Senator Sanford.

Senator Hecht.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you, Mr. Chairman.

Mr. Chairman, it's nice to see you again.

Very simply, I feel this session of Congress is going to have to make a decision after 50 years. Are we going to legislate or is the marketplace going to legislate? And I think that is what we are going to have to address and I think that is what's going to be with us the next few years and I hope each of the speakers will address that today.

Thank you.

[The complete prepared statement follows:]

STATEMENT OF SENATOR CHIC HECHT

COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS

JANUARY 21, 1987

Thank you Mr. Chairman, and Good Morning. First of all, I would like to welcome the very able new members who have joined us on the Committee this year.

As we are all well aware, the important issues we have before us today have all been completely discussed and debated over the past few years. And many in the banking and financial system now see the urgent need for prompt legislative action. I wholeheartedly agree with this viewpoint. We have to realize that the marketplace is a changing one, and every effort must be made to allow our financial services industry to remain strong and competitive.

However, because of the serious ramifications of our actions, I believe we should proceed in an orderly and thoughtful manner. We simply cannot afford to make a mistake in judgement.

There is no doubt that certain issues demand our immediate attention. Recapitalization of the Federal Savings and Loan Insurance Corporation is of course essential, and I commend Senator Proxmire for getting down to business so early in the session. I look forward to hearing from the esteemed panel assembled before us today. Thank you.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Sasser.

Senator SASSER. Mr. Chairman, I have no opening statements nor opening observations. I simply will wait and look forward to the testimony from Chairman Volcker.

The CHAIRMAN. Senator Dodd.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Mr. Chairman, very briefly, I think it's important because we're getting, I think, a sense already in the committee at our very first meeting here of possibly some consensus at least about an approach. We may disagree about what we ultimately want to do in the area of deregulation, but I too would like to add my voice to those that have already spoken and would suggest that I think on a number of issues there is no reason for us to wait. There are a couple of questions that need to be addressed and should have been addressed in the last Congress but were not. I think as quickly as we can deal with those questions we ought to deal with them and not try to tie everything up in one comprehensive package.

So I would urge that on at least four out of these five issues that we act expeditiously.

On the issues of powers and deregulation, I couldn't agree more with what Senator Gramm has said and I think a couple of others on that side as well as on this side, and that is the notion that somehow we were going to let this issue be resolved by having competing interests sort of work it out among themselves and come to us with a compromise and that would become the basis of legislation. Well, my own view is that's not a very intelligent way to approach an issue as complicated as this and as important as this.

I don't think we need to spend another Congress on it either. I think that would be the alternative mistake we could make. I think we do need to look at the policy questions here and, unfortunately, we have been tied up it seems to me in some of the means. Deregulation has in the minds of many been an end rather than a means to an end, and I think this committee, at least for this member's part, is open on that question when it comes to powers. I'm not closed at all, but I would like to see us address it as a policy question and not try and tie it up with check hold bills and FSLIC legislation and the like.

So my hope would be that we would deal with these four or five issues that we can deal with it seems to me very quickly and then get about the business of really exploring the policy questions so we don't end up with deregulation by loophole or deregulation by regulators but rather it is, as you suggested, Mr. Chairman, the subject of debate and consensus in this committee and then in the full Senate and ultimately in the Congress of the United States.

The CHAIRMAN. Thank you, Senator Dodd.

Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Mr. Chairman, first I am very appreciative of the opportunity to serve on this committee. I had an opportunity in an earlier life to testify before this committee and I appreciate its courtesies that were extended to me at that time and I look forward to being a constructive part.

I also am pleased that our witness list starts today with Chairman Volcker. I share the high regard stated by Senator Sanford for his great service to this country which I hope will be a service with many chapters yet to be written.

I come to this committee from the perspective of having dealt with many of these issues as they impact a State that is undergoing dynamic change in its own financial institutions and I share the sentiment that there has been a vacuum created in terms of Federal leadership on many of these issues, a vacuum which is being filled by episodic responses either through entrepreneurial financial institutions and individuals or by other levels of government.

The system would be better served by a new structure, an architecture, from the Federal Government that would give some direction to all of those individual entities. I commend you for taking this broad strategic approach and look forward to participating.

The **CHAIRMAN**. Thank you, Senator Graham.

Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **RIEGLE**. Chairman Volcker, you've got a lot of friends here today and I want to add my name to the list of those who hope that we will have you around for some longer length of time.

The one thing I would hope that you would address today is—and many people touched on it in their opening comments—and that is, with the revolution in financial services that's underway and all of the overlapping that's developed both in terms of private market initiatives, but as well as decisions that have been made by administrative agencies and even the courts, it seems to me that underlying this whole question is the degree to which banking and commerce ought to be commingled or kept separate.

And I think we really have to examine that question very carefully in a sense separate and apart from all these other developments, and then try to bring these things together. So I would hope that today as best you can that we could maybe hear your best argument, if you care to advance one, as to why commerce and banking are different and separate and perhaps ought to be. And if you feel otherwise, then to so state.

The **CHAIRMAN**. Thank you, Senator Riegle.

Senator Cranston.

Senator **CRANSTON**. I have no opening statement. I am delighted to welcome you, Paul, once again to this committee.

The **CHAIRMAN**. Well, Chairman Volcker, you are the man of the hour. You've got 10 minutes.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **VOLCKER**. Well, you give us a tough challenge, Mr. Chairman, to condense our remarks in 10 minutes, but I am assisted by the fact that I think the thrust of my statement and the thrust of my remarks are in one sense very simple.

URGENCY OF IMMEDIATE LEGISLATION

What I want to do is urge you to move ahead just as fast as you can on all the elements of the legislation that you have outlined, Mr. Chairman, in calling these hearings. It seems to me all of those particular issues have been fully debated in one way or another. Nearly all the elements have passed the Senate before. I realize there are some new members here, but presumably they are on the committee to go to work and I'm confident that they can get up to speed in a hurry.

Now let me just try to clear up a little the semantics in my mind. I do not consider the program that you put before the committee a comprehensive bill. I agree that there are many areas—powers, what you do with the insurance system, what you do with the regulatory apparatus over time—that inevitably require more debate. I hope you can do that as soon as possible. You have just taken a few particular pieces which seem to me for various reasons are matters of very great urgency today. Some of them are labeled emergency—FSLIC recapitalization, easing of interstate mergers for failed or failing banks—but whether or not the pieces are labeled emergency in that sense, it seems to me other parts are equally urgent for different reasons. And I want to emphasize that.

They demand immediate attention. I am thinking of the separation of commerce and banking question. I am thinking of certain limited powers that you have raised because those questions are being settled, as many of the Senators have said, in the private markets by competing private interests, by differing and conflicting regulatory decisions trying to interpret both the letter of the law and the will of the Congress. But the letter of the law and the will of Congress as expressed is often 50 years old. It does not apply to today's circumstances. Decisions are being made for you and if you're not going to make them they are going to be made and they are going to be made in a way that I think is anomalous, arbitrary, and unreasonable. That will produce results that nobody is going to like.

Now so far as the so-called emergency provisions are concerned—the FSLIC recapitalization for instance—I will be very brief. I see no alternative, given the current condition of the FSLIC, to taking some action to improve its liquidity. That's a proposal on the table and I suggest you certainly include that in any legislative package. I don't think that's the whole story about the savings and loan industry or FSLIC. Many people in the industry have raised questions about the permanence and consistency of a better supervisory effort. I think that's something you are going to have to consider. That's something that certainly should arise in a subsequent, more comprehensive bill.

We proposed last year, and the Senate passed, means of easing interstate mergers for banks. Given the critical situation in some States, in some ways that problem has been relieved—certainly in Texas and Oklahoma because the States themselves have gone ahead and taken action. But problems remain elsewhere and I would certainly recommend that that kind of legislation be included in the package.

Another brief word about the consumer issue—the check hold issue—that has received very widespread interest. The current situation, for good reason, is considered unsatisfactory. We do need legislation if we in the Federal Reserve are going to be successful in speeding up the check return practice.

Disclosure is certainly called for. We support that, and if the committee wants to provide for setting actual limits on the number of days, we would propose that you delegate that to us so it can be done in a reasonably flexible manner, depending upon the actual technological capabilities of the system. We would be happy to work with you in developing legislation very promptly to achieve those purposes.

Now the other two issues may be more controversial judging from some of the comments of Senators. Let me address those.

First of all, there's the area of new powers essentially for bank holding companies. There's no question this whole area needs to be reviewed, but I don't think all the issues can be settled there—questions of insurance, insurance brokerage, insurance underwriting, real estate brokerage. A number of other questions also arise. I don't think they are a matter of great urgency but I think they should be done. It's not a matter of great urgency over the next month or two.

DEALING WITH SECURITIES POWERS

What is, it seems to me, essential that you deal with over the next month or two is the question of certain securities powers. Whether you like it or not, these questions are on the table. They are on the table for the Federal Reserve. They are on the table for some States. Changes are being made. We ruled recently that placement of commercial paper is all right. Other applications as to what bank affiliates can do are before us for decision on mortgage-backed securities and municipal revenue bonds. A decision will be made if you don't act. A decision will be made if you do act.

The question is whether that decision is going to be rational and logical. We have long supported as a matter of competitive equity, better competition in markets, better services to customers, and consistent with safety and soundness, that bank holding company affiliates be permitted to underwrite revenue bonds, mortgage-backed bonds, commercial paper, and mutual funds. And I think that authority should be provided straightforwardly by the Congress with appropriate safeguards. That's the only way it can be done logically and straightforwardly. It is simply crazy to let this process proceed through interpretations of present outmoded law and by a variety of different regulatory decisions and State actions which may be inconsistent with themselves.

Among other things, present law, to the extent it's done, creates artificial incentives to move assets out of banks to build up affiliates so the affiliate is big enough so that it can engage in these activities and not be said to be "principally engaged." That doesn't make any sense. It's not consistent with the strength of the banking system.

Under interpretations of present law, some large banks with large affiliates will be able to do it and others will not be. It makes no sense at all to proceed in that way. What we need is a straightforward, procompetitive, proservice to the customer, congressional authorization and we need it right now because these decisions are going to be made in any event.

NONBANK BANKS

Now finally, the question of nonbank banks. It sounds very technical. It really raises the question that Senator Riegle just referred to—in what direction do we want this banking system to go? Do we really want conglomerates of commercial and general business firms in the banking business?

That clearly has been against the traditions in this country for very good reasons and I think this rather technical-looking decision you make about nonbank banks really is determining the framework that you want banking to go in the future, whether we are going to depart from the traditional separation or whether we are not.

I know of no better statement, frankly, in summarizing this issue in just a few sentences than a statement made by President Nixon, who wasn't exactly a wild-eyed radical or a populist, at the time of the last amendments of the Bank Holding Company Act. He simply said:

> Left unchecked, the trend toward combining banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen. It would be bad for banking, bad for business, and bad for borrowers and consumers. The strength of our economic system is rooted in diversity and free competition. The strength of our banking system depends largely on its independence. Banking must not dominate commerce nor be dominated by it.

What we have now is, of course, this movement to exploit what was considered by the Congress to be a very narrow loophole for what are called nonbank banks by commercial firms as well as by others. But what really bothers me is the movement by commercial firms because that is where this principle gets involved. I think it is quite clear that if this process proceeds unimpeded we are not talking about a few small nonbank banks. The argument will be made to you now we all have nonbank banks, meaning they can either do a consumer business or a commercial business but not both. It doesn't make sense; we'll set up both of them. But obviously the efficient thing is to combine them and then we simply have a commerce and banking combination in full-blown form.

Well, what's the matter with that? I think it does, as President Nixon's statement suggests, lead to the possibility and the reality of combinations of activity. Suppose we have our banking run by various commercial firms all over the country with offices in retail chains and so forth. Will those banking offices serve the general needs of other borrowers in the local community? Suppose the local appliance dealer comes in to ask for loans from a bank run by a large retail chain. I suspect that branch manager isn't going to be very happy to provide the money to the local retail establishment. If he does, I suspect he is going to find himself selling shoes instead of running the bank office before very long.

What does it mean with access to the payment system by large commercial firms with all the risks that that may imply, where you have no credit check——

The CHAIRMAN. Mr. Chairman, I apologize for interrupting you. What I'm going to do is ask you—on my time—to finish your statement on the nonbank bank. I'm going to announce in accordance with our rules each member will be allowed 5 minutes to question you in the first round and so you finish your statement on the nonbank banks and then I'll proceed with my question.

Mr. VOLCKER. Well, I would simply conclude by pointing out there are questions of risk to the payment system. We do not want to regulate commercial firms. Banking is a regulated and protected industry. I think it's going to remain so. This is true in all countries. When you regulate it and protect it you don't want to regulate and protect the whole economy. That's not consistent with the free enterprise system. But since inevitably if you are part of a larger organization the risks of that whole organization devolve upon all parts of the organization, you raise the question of how far the regulatory reach goes and if it doesn't go very far, then what risks are you posing for the banking system.

[The complete prepared statement follows:]

For release on delivery
10:00 A.M., E.S.T.
January 21, 1987

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

of the

United States Senate

January 21, 1987

I welcome this opportunity to provide the views of the Federal Reserve Board on the legislative issues before the Committee. As you, Mr. Chairman, aptly observed in your letter of invitation to appear at this hearing, these issues, for the most part, have been thoroughly reviewed and debated over a number of years and now cry out for legislative action.

I cannot emphasize strongly enough that a strong, stable, and competitive banking and financial system is an indispensable ingredient of a healthy and growing economy. Plainly, inescapable forces of change -- technological, economic, and competitive -- at work on an international scale require appropriate and effective response if the broader public interests at stake are to be served.

But the simple fact is that today, in the absence of fresh Congressional direction, that objective is in jeopardy. Both thrift and bank regulators need additional tools to deal with pressing problems. More generally, important principles that have long guided our financial system, and that seem to me integral to its lasting health and stability, are being undermined. Particular institutions and segments of the financial industry are responding to the shifting competitive pressures and their perceived self interests by exploiting loopholes and inconsistencies in present law in ways that will ultimately threaten the integrity of the whole.

The point is not, of course, that forces of change can or should be stifled. Rather, those forces should be channeled in a constructive way. There are clearly areas where market competition should be freed and efficiency promoted. At the same time, there are clearly areas where institutional stability and independence need to be protected by maintaining an appropriate legislative and regulatory framework.

As a practical matter, the controversy and complexity surrounding this area mean that really comprehensive review of the legislative structure -- the range of powers of banking and financial holding companies, the role of deposit

insurance, changes in the regulatory apparatus -- surrounding this area must take some time. No doubt, it's too much to accomplish in one fell swoop. However, there are areas in which action cannot wait, both because there are particularly pressing needs and because they will signal the broad framework within which more thoroughgoing reform will take place. It is in that context that I strongly welcome the plan quickly to formulate a limited bill on the basis of the present hearings (and those of recent years) and to seek Committee markup and Senate action early in this session.

The immediate issues fall in four general areas, and they all are ripe for action. The "emergency" need for measures to bolster the ability of the insuring agencies to deal with failed or failing banks and thrifts was made convincingly in the last Congress. The time has plainly arrived to clarify and expand certain securities powers of bank holding companies, a matter that simply cannot be dealt with reasonably and rationally without Congressional action. There is widespread interest in improving the process of check collection in a manner that will speed the availability of funds to depositors in financial institutions. And, it is evident that the long-standing national policy of maintaining a basic separation of commerce and banking and a basic unity between state and federal banking authorities is being eroded; that process needs to be halted before irretrievable damage is done.

Action in all those directions seems to me entirely consistent with the desirable longer-run evolution of the financial system, and therefore need not be delayed awaiting more comprehensive legislation. To the contrary, failure to act can now only complicate, and likely thwart, further constructive reform.

The Basic Separation of Banking and Commerce

This Committee has repeatedly considered the so-called "non-bank bank" (and "non-thrift thrift") question over several years without resolution. In one sense, the issue is technical, involving the increasing exploitation of what was considered at

the time of enactment a narrow loophole in the Bank Holding Company Act. However, as commercial firms have increasingly moved to exploit that loophole in their individual interests, and as thrift institutions have assumed banking powers, the more basic issues at stake have become apparent.

Essentially, the non-bank bank has become a device for tearing down the separation of commerce and banking by permitting a commercial firm to enter the traditional banking business without abiding by the provisions of the Bank Holding Company Act. That is accomplished by establishing banks that refrain from making commercial loans, or by establishing banks that refrain from accepting demand deposits, or potentially by establishing both types of banking affiliates that, somewhat awkwardly, would together provide the full range of banking services.

At the same time, some established commercial banks have sought to use the "non-bank" device to expand interstate. However, the incentives to do so are being reduced by the rapid liberalization of interstate banking restrictions by the states themselves, and that particular use of the non-bank bank is not a matter of strong policy concern to us. However, the potential of existing banks to split themselves into two non-bank banks as a means of avoiding the provisions of the Bank Holding Company Act entirely, while still more theoretical than real, illustrates the basic nature of the issue before you.

Fundamentally at stake is not a few inhouse consumer banking offices of some retail chains or operational access of some companies to the payments system, services which can be efficiently provided in other ways. Rather, you are presented with the question of deciding upon the nature of the banking system you want to see evolve in this country.

I believe we need and can support a strong banking system with a variety of units large and small, able to compete efficiently, and capable, if they wish, of participating through affiliates in a wide range of financial services to consumers and businesses alike. At the same time, we want to protect against instability, excessive

concentrations of power, and undue conflicts of interest, while preserving an institutional framework for the effective conduct of monetary policy. In seeking those goals, the separation of banking and commerce has been a basic part of the American tradition for what seems to me sound reasons.

Handling other people's money, which is what banking is all about, connotes a fiduciary responsibility -- to invest those funds prudently while making loans available competitively, productively, and impartially to all sectors of the economy. To that end, banking systems in virtually all countries are regulated, and in one way or another the depositors are offered a degree of protection by means of a public "safety net." All of that reflects a fundamental recognition -- from the writings of Adam Smith on down -- that banks play a particularly strategic role in the economy that requires some regulation and support. The interdependence between the fortunes of one institution and others, and the dependence of all on maintenance of a basic confidence in the stability of the whole, imply a special sensitivity to risk and the general interest that is no less important today.

The Bank Holding Company Act itself rests on the philosophy that banking cannot be treated as just another business, with its fortunes entirely subject to the vagaries of the marketplace. It permits banking organizations to engage in related financial businesses. A degree of "separation" is required between affiliates and a bank within a holding company, both for prudential and competitive reasons. However, there is also some surveillance of the whole, recognizing insulation cannot be complete.

No doubt, as I will urge later, the legitimate boundaries of activities permitted by banking organizations need to be reviewed and enlarged. But to extend the interrelationships to business and commerce generally would be a change not of degree but of kind. We certainly do not want to undertake new regulation of non-financial businesses or incorporate them within the public safety net. But without that regulation, how would we protect against new dangers of concentration, conflict of interest, and instability?

What is suggested by some is that strong walls can be built to insulate a regulated and supervised bank from its non-banking and commercial affiliates. As I just indicated, a certain "separateness" is already enforced within a bank holding company. But the insulation is far from complete, and attempting to make it so would present very great practical difficulties.

Common ownership of businesses implies common direction -- why else would they want to join together? In particular, the fortunes of one unit rest on the performance of others, especially in an area so sensitive to confidence as banking.

All our experience with the Bank Holding Company Act points to the strong incentives of management to support all parts of the organization when they come under pressure. That is understandable because it is demonstrable that weakness or failure of one part of a holding company can rapidly spread to others. The legal doctrine of corporate separateness of affliates can and has been challenged in the courts when common direction and management is present. And, suppose we succeeded in building full and credible insulation between a bank and its affiliates -- no direct or indirect transactions among them, no common officers, no tandem operations, no possibility of mutual support or greater capital leveraging as part of a banking organization -- then, I would ask, what is the economic incentive for such combinations at all? Certainly, present restrictions on linkages between banks and other parts of a holding company are often resisted by management.

We are asked to look to foreign experience with "universal" banking systems as justifying greater integration of banking and commerce. But frankly, I don't find much comfort there. We have never been admirers of the old Zaibatsu system in Japan, which led to enormous concentration of finance and commerce. German banks have long had a sizable ownership stake in some industrial companies. Even now, that arrangement

is under strong attack within Germany itself as anti-competitive and stifling to the development of equity and capital markets.[1] Italian authorities, reacting to experience, are moving to restrict non-bank ownership of banks more forcibly, arguing that "firms controlling banks . . . involved large segments of the banking system together with savers in their crises" (that is, in crises of the controlling commercial firm).[2] Our Canadian neighbors, in proposing sweeping changes in the organization of their financial system including a broader range of *financial* services for banking organizations, have indicated a special sensitivity to forestalling any sizable combinations of banking and commerce.[3] And, in fact, whatever the formalities of the law, there are few instances in

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[1] See generally, Academic Advisory Commission to the Ministry of Economics, Federal Republic of Germany, *Policies on the Enhancement of Competition*, December 5-6, 1986. Monopoly Commission of the Federal Republic of Germany, Main Report, 1980-81.

[2] *Inquiry into the Development of the Banking and Financial System and the Relevant Legislation*, Statement of Governor Carlo A. Ciampi, Bank of Italy, before the 6th Standing Committee (Finance and Treasury), Chamber of Deputies, Rome, Nov. 28, 1986. pp. 11-12.

[3] Communique, Department of Finance, Canada (86-210), Remarks by The Honorable Thomas Hockin in the House of Commons on tabling the policy paper, "New Directions for Financial Institutions" (December 18, 1986).

industrialized countries of commercial firms owning important banking institutions.

That is, of course, the situation in the United States today. The non-bank bank phenomenon is recent and, as yet, poorly developed. Excluding industrial banks, there are 79 FDIC-insured non-bank banks, not all of which are in operation. Of those, 17 are owned by banks or thrifts, raising only the question of interstate banking which in any case is in a state of flux. Most of the remainder are affiliates of financial firms; while these are inconsistent with the spirit of the Bank Holding Company Act as now written, they do not, except incidentally, violate the basic separation of banking and commerce. Only the remaining 13 with total assets of some $1.7 billion are affiliated directly or indirectly with firms primarily engaged in commerce. Half of those assets involve only one firm.

Many of those relationships were established with fair warning, after grandfather dates proposed in earlier legislative proposals, and are not yet integral to the successful operation

of the parent. But that will change. The time has come, it seems to us, for Congress to set out the "rules of the game" clearly and specifically, before a reasonable case can be made that, de facto, the issue is moot.

For that reason, we would welcome early legislation to redefine a bank along the general lines of the bill that passed the Senate as early as 1984 -- essentially to include FDIC-insured banks and non-insured banks that take transactions accounts and make commercial loans. Existing institutions might be grandfathered so long as their operations are not expanded or operated in tandem with their affiliates. Taking a leaf from the Canadian proposals, control might be shifted to public ownership (with full banking powers) as expansion takes place. Whether non-banks owned by financial firms should be permitted to expand or become full service institutions should be governed by the range of powers open to bank holding companies.

Similar restrictions would be appropriate for "thrift" institutions that in fact operate like commercial banks. But exception could be made for savings and loan associations or savings banks that in fact continue to operate primarily as specialized mortgage lenders without their operations integrated with those of affiliates. That would continue, in practical effect, the existing position of a number of thrifts, some of which have long been owned by commercial firms as independently operated businesses through the vehicle of a unitary thrift holding company. Such an approach would incidentally provide a vehicle for commercial firms to purchase troubled thrifts so long as they chose to commit themselves largely to the residential mortgage market.

The South Dakota Loophole

For more than 100 years, the United States has had a "dual" system of banking law and regulation, dividing chartering and supervisory authority between the state and federal authorities. While that approach is bound to give rise to certain tensions, in general it has operated constructively by providing a certain room for difference and experimentation among the states, and between the states and the Federal Government. At the same time, it is evident that the safety and stability of the banking system as a whole is a national concern -- a concern reflected specifically in the existence of the Federal Reserve and the Federal Deposit Insurance systems. The dual system works well when that overriding interest is respected.

Recently, there have been developments that challenge that basic assumption. Some states, zealous to attract jobs and revenues from others, have moved to grant new powers to their banking or thrift institutions far beyond that allowed federally chartered institutions. South Dakota, in doing so, adopted the unusual approach of permitting certain of those powers to be exercised effectively only outside the borders of South Dakota itself.

That form of potentially destructive interstate competition -- the exercise elsewhere of powers deemed unsuitable for the state itself -- should be eliminated. Moreover, it should be clear that new powers, whether or not exercised within the chartering state, that clearly jeopardize the safety and soundness of banks and thrifts, or violate the basic separation of commerce and banking, with adverse consequences for the federal insurance funds and the financial system as a whole, can be curtailed or overridden by the appropriate federal authorities. We believe clarification of existing authority and a fresh Congressional expression of intent along those lines would be desirable and we would be glad to propose language with that effect.

Securities Powers

Resolution of the non-bank bank issue and clarification of the legitimate role of states in banking regulation does not dispose of the practical issue of resolving the proper scope of powers of banking holding companies in the general

area of financial activity. We have long urged that the Congress recognize the competitive, technological, and international forces at work in the banking and financial marketplace and expand the authorized role for bank holding companies.

These issues are inevitably highly controversial for they affect the competitive environment of existing institutions. No doubt, a full redefinition must await more comprehensive legislation. But there are areas in which progress is clearly possible now, and where change is in any event underway. The only question is whether that change will be piecemeal and haphazard as it works its way through the intricacies of present outdated law, with odd and anomalous results, or whether that change will be channeled along more clearly constructive lines.

That is precisely the issue today with respect to the securities powers of banks and bank holding companies. The Glass-Steagall Act, written more than a half century ago, has been commonly interpreted as calling for the "divorce" of investment from commercial banking (with the exception of U.S. Government securities and the general obligations of state and local governments). But it is also true that the literal language of the law, with respect to bank affiliates, indicates vaguely that such affiliates may not be "engaged principally" in prohibited securities activities.

The Federal Reserve Board recently interpreted that language to permit, with strict limitations on volume, sale of commercial paper by a commercial lending affiliate of a bank holding company. We have under consideration applications to permit underwriting of mortgage-backed securities and municipal revenue bonds as well as commercial paper in affiliates largely engaged in trading government securities, which present additional legal and practical issues.

We have long felt, as a matter of good public policy, that all these activities are appropriate for bank holding companies without artificial limitations on the volume of operations. But the issue before us is whether that result can be achieved, legally and reasonably, under existing law.

One thing is evident. Existing law provides a strong incentive for certain large banking organizations to transfer assets and activities out of the bank itself into a non-bank affiliate so that affiliate's otherwise prohibited securities activity will be small relative to the whole. Moreover, only the largest bank holding companies will be able to muster a sufficiently large asset base to make the otherwise prohibited securities activity commercially economic and attractive.

That cannot be a sensible result from the standpoint of either public policy or private interests. The effect is both to artificially encourage the reduction of assets in the regulated and protected banking system and to impose unnecessary restraints on competition. Yet it is the situation in which we find ourselves. And, we cannot defer a decision on this matter much longer. We have scheduled public hearings for early February and a decision in April.

But only Congress can provide a really sensible approach consistent with safety and soundness of the banking system, effective competition, and the interests of borrowers and lenders alike. To that end, we strongly support the suggestion of the Chairman that straightforward authority be provided, as part of an early legislative package, for affiliates of bank holding companies to underwrite private securities backed by 1-4 family residential mortgages, municipal revenue bonds, commercial paper, and mutual funds. Because these are active, growing markets and potentially important sources of revenue, action in this area would go some distance toward meeting the legitimate concerns of banking organizations that they cannot keep abreast of growing sectors of the financial markets even when safety and soundness or conflict of interest considerations are not persuasive deterrents.

Opposition to these powers is almost entirely limited to investment houses now with the field to themselves. We have long been convinced that with appropriate prudential

safeguards and protections against self-dealing, these powers can be exercised consistent with the safety and soundness of the banking system and the interest of the public at large in effective competition.

While urging action on these powers now, we would also encourage the Committee to consider other financial areas appropriate for bank holding companies. I recognize these areas -- including insurance and real estate brokerage, insurance underwriting, and corporate security underwriting -- are more controversial and will take more time to resolve. They, together with other important issues (including simplification of the procedures required by the Bank Holding Company Act) can await more comprehensive legislation later in this year or next year. But to that end, I hope the Committee will not act to foreclose further any of existing opportunities of bank holding companies to provide financial services.

The **Chairman**. Thank you very much, Mr. Chairman.

Mr. Chairman, I've heard you speak many times before this committee, maybe 50 or 60 times, but in condensing your statement to 10 minutes you have made the best statement I've ever heard you make. And I say that although you have made many fine ones.

Let me mention that Senator Garn apologizes for his absence today. He is en route to Washington and will make an opening statement at the beginning of the hearing tomorrow.

On January 12, Secretary of the Treasury Baker made a speech at the opening of the Garn Institute in which he stated:

> People are recognizing that it makes sense to permit anyone to own a bank as long as the insured deposits, the payments system, and the connections to owners are regulated in a common fashion.

Secretary Baker noted that, according to a 1986 survey, only one United States bank is now among the 10 largest in the world, whereas Japan now has the largest and 7 of the 10 largest. He contrasted this with the situation 30 years ago, when 5 of the top 10 banks were American, including the top 3, and he implied that the change resulted in part from the 1930's banking regulation which stifled competition, both geographic and product, for the sake of supposed stability. That was his quote.

JAPANESE BANKS ARE LARGEST IN THE WORLD

Now what are your views on why Japanese banks are now the largest in the world? Do you think the fact that the Japanese have the largest banks has anything to do with the Secretary's assertion that we must now allow anyone to own a bank, or is the latter statement a nonsequitur in relation to his concerns over the size of Japanese banks?

Mr. **Volcker**. Well, Japanese banks are the largest in the world probably because the Japanese yen has been appreciating in value, partly because they have a highly concentrated banking system and partly because that country is now demonstrating an enormous capacity to save internally and externally.

But these rankings of bank size internationally where, interestingly enough, the French and the Japanese banks dominate the very largest banks in relative size, are a reflection of the banking structure within those countries. They have highly concentrated banking structures, so naturally individual units are bigger.

I have not heard any concern over the years that U.S. banks are not active competitors internationally. They have been at the cutting edge of international banking competition and we have very active international competitors among the American banks. They are certainly among the most active, if not the most active, in the Eurodollar market, right on the doorstep of all the European banks. International competition is as much a matter of quality as it is size, once you get beyond a certain threshold. Obviously, you need some substantial size to compete effectively internationally.

I would point out that even in Japan the most active, forceful, aggressive, international competitor is the Bank of Tokyo which ranks 29th. It's one of the smaller worldwide and is one of the smaller Japanese banks. You don't need to be the biggest one in the world—the biggest banking organization in the world happens to be an American bank—but it doesn't require that you dominate that top 10.

The CHAIRMAN. Thank you, Chairman Volcker.

Chairman Volcker, I am aware from our previous discussions of safety and soundness matters that you're confident in the ability of the Federal regulators to deal with any problems that may arise. As you know, I don't share that confidence. The real estate investment trust [REIT], foreign lending, and off-balance sheet excesses went further than they should have. I'm sure we have not reached the end of the list of the ways bankers can make mistakes.

I am concerned that regulatory and supervisory resources are stretched thin now, and in a world permitting nonbank banking the situation will only worsen. I am concerned that there is no way the regulators will be able to police the activities of the vast number of privately owned pocket nonbank banks and the hugely more complex activities of international bank subsidiaries of worldwide diversified holding companies.

I know you are confident in the ability of regulators to handle problems. Do you foresee long-term regulatory and supervisory problems from failing to close the nonbank bank loophole? You have answered that in substantial part. Would you like to supplement that in any way?

Mr. VOLCKER. I don't think it's any problem at the moment because these are very small. They are just starting. It's not a big deal at present. But the implication is certainly very severe for the ability to regulate and manage and protect the banking system.

The CHAIRMAN. One other question. A number of banking analysts have recently argued that our banking industry and especially our money center banks are caught in a profitability squeeze and that the only way out is for the Congress to give these banks substantial new powers so they can make more money.

You mentioned substantial powers, but is that the driving reason for them, in your view?

Mr. VOLCKER. No, but I think that is perhaps one reason. I think the banks are under heavy competitive pressure, as much as anything else, from problems of asset quality, but I think there are competitive problems here. Some competitive adaptations need to be made. But one of the curiosities of this debate is that the banks argue they want to get in other areas to improve their profitability and those other areas argue they want to get into banking to improve their profitability and that banking is a pretty profitable and attractive business. I wonder whether they both can be right or whether synergy really produces all those results.

I am also interested in observing that some present nonbanking financial conglomerates have recently undertaken to divest themselves of some arms of their activities. Merrill Lynch is selling its real estate brokerage arm. American Express, that acquired an insurance company some years ago and looked toward a lot of synergies, has since taken a lot of losses in selling that particular source of synergy. One of the larger nonbank banks has recently been sold to a bank.

So I think there's a certain amount of fashion in thinking about conglomerates, but there has been in the past in other areas and sometimes they don't all work out just the way the emotions of the times suggest.

The **Chairman**. Thank you, Chairman Volcker.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you.

Chairman Volcker, I want to join with Senator Proxmire in commending you on an excellent statement. I thought you were particularly forceful in arguing about dealing with the issue of nonbank banks. It's an issue on which, I think, many of us on the committee share your interest and sense of urgency in dealing with it. This committee has tried to do that on previous occasions.

EXPANDED SECURITIES POWERS FOR BANKS

While there are some questions I could ask you about that, I want to go back to the issue of the expanded securities powers for banks that you mentioned.

Now there are some activities for banks that you didn't mention. You didn't mention banks getting into insurance activities. You didn't mention banks getting into real estate. It seems to me that you must have in your mind some kind of a continuum of types of financial services that ultimately lead to such activities as bank underwriting of corporate debt and ultimately banks getting into general commerce, which is at the bottom line of Glass-Steagall.

My question to you is, given that the four powers that you mentioned—mutual funds, commercial paper, mortgage-backed securities and municipal revenue bonds—contain, at least, in two instances some strong element of risk. I refer specifically to municipal revenue bonds, as evidenced by the case of the Washington Public Power System bonds and, in the case of mortgage-backed securities, the difficulty of at least one securities firm last year.

Why do you draw the line where you do draw it and is your criteria risk or is it something else?

Mr. **Volcker**. Well, I think there are various criteria. First of all, I see something of a continuum among financial services. I do not see a continuum between financial services and commercial activity, and I think that's where the line should be drawn. I think some of these other powers definitely ought to be considered and we have proposed some of them as part of a more comprehensive package.

On these securities powers and on the particular ones that we are pressing you to support right now, obviously there are risks, but we don't think that they are exceptional questions of risks nor—and this is important in your question—do they pose possibilities for the same kind of conflict of interest and self-dealing that might be raised more forcibly, let's say, with corporate underwriting. I think you ought to look at that too. But these problems, to the extent they exist in this area, seem to us totally manageable.

Senator **Heinz**. Now you were not testifying in favor of us including corporate underwriting?

Mr. **Volcker**. Not at this time.

Senator **Heinz**. Or including insurance?

Mr. **Volcker**. That is correct.

Senator **Heinz**. Or including real estate?

Mr. VOLCKER. Not in this bill. I think you ought to look at those as part of a more comprehensive bill, but not as a matter for immediate action.

Senator HEINZ. Would you take maybe 30 seconds to elaborate on why corporate underwriting would be risky?

Mr. VOLCKER. Well, I think in corporate underwriting where you are dealing with commercial customers that have other relationships with the bank, you have a question in the public sale of securities. You have additional questions such as to what extent the sale of securities might be motivated by other interests of the bank other than the interest of the customer in selling those bonds at attractive rates to the public. That is an area that presents more complications, let's say than a mortgage-backed security with one to four family residential mortgages backing it, where those kinds of important other relationships are not involved.

I think corporate securities underwriting is being done in substantial volume abroad under existing law. Many new issues are arising in that area because of the securitization of bank assets. So I think that ought to be looked at and I think it ought to be looked at in a neutral kind of way so that some decision can be made at an early date. But I do not think it is ripe for decision now either way.

ENTHUSIASM FOR FOUR SECURITY POWERS FOR BANK

Senator HEINZ. Getting back to the four security powers for banks you mentioned, to what do you attribute the lack of bank customers, be they small depositors or be they commercial customers of banks, coming to the Congress and urging the Congress to allow banks to enter in and compete in those areas? It would seem logical to me, if this was a good thing to do, the people who would benefit from doing it would be bank customers and yet bank customers are very nearly silent on this issue.

Mr. VOLCKER. Well, it is my understanding that in the area of revenue bonds that is true, that State and local government officials do very much favor bank activity in this area.

When you get into mortgage-backed securities, the customers on the borrowing side are a very diffuse group of individuals that I think are not going to be organized in a way that appreciates the cumulative effect. And I would say the burden of proof might be on the other side. Unless there is some damage done here, why not? Because the normal presumption would be that it increases competition, and I think that's true in this area. There is a well-developed market in mortgage-backed bonds. I think that market probably would be better off if banks participated in it and there are no real dangers in it.

I am given a note by one of my associates that the homebuilders do favor banks in the mortgage-backed area. I think in the mutual fund area it will make it more convenient for individuals or businesses to have access to mutual funds managed by banks in various parts of the country. As for commercial paper, I'm sure some business corporations are interested in getting more competition in that market which is a highly concentrated market.

Senator Heinz. Chairman Volcker, I thank you. In fairness to the others, my time has expired.

The Chairman. Senator Dixon.

Senator Dixon. Mr. Chairman, on page 13 of your statement you refer to the whole question of nonbank banks and I would like to pursue that a little further with you because I think this session of the Congress and certainly this committee will spend considerable time on this.

Essentially, you suggest what is probably obviously the easiest solution, which is to say that we grandfather the existing nonbank banks in and provide some kind of a date for that and then prevent the proliferation of nonbank banks in the future.

First of all, what kind of a date would you suggest, something contemporaneous with the passage of the bill?

GRANDFATHERING NONBANK BANKS

Mr. Volcker. I think that is possible. I haven't got a specific suggestion along this line, but at the extreme—and many of these institutions were warned that there would be a much earlier grandfathering date by this committee in the past——

Senator Dixon. Beginning when were they warned, Mr. Chairman?

Mr. Volcker. But suppose they said, "Look, you can't expand, you have to be isolated from the operations of your company and that if you do grow you've got to go public." I think that would provide adequate protection if you would move in a different direction.

Senator Dixon. Well, to refresh the recollection of this committee, when did you begin to notify nonbank banks of the potentiality of problems in the formation of them? Was it sort of around the time in 1984 when we passed the bill on the Senate side?

Mr. Volcker. There was a lot of public discussion with this committee. I think the warning in a sense was delivered by the chairman and ranking member of this committee, and the House committee too, that at various times they announced these were the grandfather dates that were going to be adopted, and that was some time ago.

Senator Dixon. Now you say here—and I just want a clarification, Mr. Chairman—"existing institutions might be grandfathered so long as (1) their operations are not expanded"—you don't number them but I am—or (2) operated in tandem with their affiliates. Well, I suppose you could do the second thing by holding companies or something. How do you propose to "grandfather in so long as their operations are not expanded?" Would you suggest to me the policy factors that we ought to consider in legislation to do something like that?

Mr. Volcker. Well, I don't know what further amplification that takes. The next sentence here refers to something I read about in some Canadian proposals where they are very sensitive to the same issue. They are introducing some rather large changes within the financial services area of the type that you have under consideration. In some of these, we are ahead of them. But they say, "Look, we are very sensitive to this question of commerce and banking." And some of the things they are incorporating into banks are

I would particularly urge the Committee to undertake hearings or other studies in the area of corporate underwriting -- a process that we would be pleased to support. Clearly the issues in this area are more complicated because of the greater potential for conflicts of interest. However, they cannot be evaded much longer. A very substantial amount of such activity is already conducted by bank holding companies abroad and the increased securitization of financial assets by banks and others, requires fresh consideration of how banks participate in that process. Moreover, the issue could well arise as a matter of interpreting the present provisions of Glass-Steagall.

Emergency Provisions

The need for additional liquidity for the FSLIC is plainly urgent. I know that you have in the past, and will again, be receiving detailed testimony on the Treasury-FSLIC proposal for recapitalization of the insurance fund by leveraging the existing surplus of the Federal Home Loan Banks and providing for special assessments on insured institutions. I know of no

practical alternative at this time to that approach, nor is the time available to delay action while considering other possibilities that would require more sweeping reorganization. Moreover, the proposed approach conceptually is correct in looking to the insured industry itself to provide the financial support needed now.

At the same time, we share the views of many in the industry that self help must be accompanied by effective supervisory and regulatory discipline to forestall aggravation of the underlying problem. Clearly, some thrift institutions have not used their existing authorities wisely or well. Perverse incentives have arisen, with deposit liabilities fully insured, to undertake high risk activities inappropriate for any depository institution.

I am aware of the strong efforts made by the Federal Home Loan Bank Board in recent years under the leadership of Chairman Gray to curtail abuses, to sharply upgrade the size and effectiveness of its supervisory effort, to work toward higher capital standards, and to regulate effectively. I believe those approaches deserve your strong support.

As part of more comprehensive legislation in the future, means of obtaining more consistency in accounting, supervisory, and capital standards among depository institutions deserve your thoughtful attention. To my mind, special consideration should be given to the role of thrift institutions that in fact want to remain largely concentrated in the traditional area of residential mortgage lending. Meanwhile, I hope you act promptly on the FSLIC recapitalization proposal.

Fortunately, constructive action by Texas, Oklahoma, and a few other states in recent months to permit the acquisition of failed or failing banks by out-of-state institutions, or to liberalize interstate banking generally, have eased the difficult job of finding buyers for actually or potentially insolvent banks. Welcome as those actions are, however, they do not address the problems that could arise in certain states. Consequently, we continue to urge that you adopt legislation along the lines

proposed to you by all the bank supervisory agencies last year,[4/] thus providing greater assurance that we can collectively act, with dispatch and at minimum cost, to deal with acute problems that might emerge.

As things now stand, with the lapse of the authorities provided earlier by the Garn-St Germain Act, we are without any federal authority to arrange inter-state acquisitions in emergency situations.

Funds Availability

The final question raised by the Chairman in considering legislation for prompt Congressional action deals with check holding practices of financial institutions. We believe such legislation has two essential elements. First, there is a

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4/ The federal regulators proposed legislation to (a) reduce the threshold amount for interstate emergency acquisitions from $500 million to $250 million; (b) permit interstate acquisition of banks in danger of closing (with or without FDIC assistance) as well as closed banks; (c) allow for acquisition of a holding company and its affiliated banks if the holding company has a bank or banks in danger of closing with total assets of $250 million or more and which represent at least 33 percent of its banking assets; and (d) permit the out-of-state acquiring bank holding company to expand in the three largest cities or metropolitan areas in the state of the acquired banking institution.

strong and straightforward case that depository institutions clearly disclose to customers their policies with respect to the availability of deposited funds at the time an account is opened and when such policies are changed. Secondly, certain authorities to override individual state statutes are necessary if the process of collection and return of checks is to be speeded (or if truncation is to be introduced), thus reducing or eliminating the risk to depository institutions of making funds available more promptly and uniformly.

In recent years, considerable exploratory work and some pilot projects have been undertaken seeking to speed the return of dishonored checks to the institution of first deposit. Progress is, among other things, dependent upon an ability to enforce expedited procedures by banks not using the Federal Reserve for check clearance. Consequently, federal legislation is necessary.

Mandatory availability schedules imposed by law raise difficult problems. Given existing technology, very tight

schedules would pose measurable risks to the depository institutions, with the potential result of curtailing the availability of checking accounts to marginally profitable (or unprofitable) customers. Liberal schedules might unduly ease pressures for more rapid availability. In any event, the nature and extent of the problem varies locally.

In these circumstances, the Board has felt primary emphasis should be placed on efforts to alleviate the problem through disclosure and improvements to the check collection process and by targeting progress toward speedier returns as in the bill before this Committee last year. However, we are aware that some states have enacted mandatory schedules that appear to be operating reasonably effectively. We believe that mandatory schedules would be workable provided the Federal Reserve is given authority to determine those schedules in the light of practical progress in speeding return item times.

We strongly believe that such schedules be established based on the times in which the great bulk of checks can, in fact, reasonably be expected to be collected and returned to the depository institution in which they were first deposited in the event of dishonor. After a relatively short transition period, we believe that schedules of from two to six business days or even less are feasible depending on where the check is drawn. The Board also believes mandatory schedules should contain exceptions to permit depository institutions to place holds on deposits or accounts presenting unusually high risks.

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owned by nonbanks—not the regular commercial banks but some trust companies—that they would combine with banks. And they say, "Look, let's solve this problem by saying if you grow you have to go public." Of course, that eliminates the problem. You lose the control as you grow.

Senator **Dixon**. Now in your comments you talk about nonbank bank issues, which I think we all agree will be a major concern here, and the question of the South Dakota concerns that we've addressed before in our 1984 omnibus bill. I think that there's probably some idea, at least on the part of some of us in this committee that have been through this a few times, that there may be some openness to these questions on the House side.

Then you get into the whole question of powers. My recollection of that whole exercise before was it was pretty complicated in the committee. We finally resolved it in a sort of an accommodating way that caused a bill to emerge that had no success at all on the House side.

I would ask you whether you would agree with this, whether it would not be the better part of political expediency to separate the question of the powers from the whole question of the South Dakota issue and the nonbank bank question if we are going to consider legislation?

Mr. **Volcker**. Well, I don't know what you mean by separating. Obviously, it's up to you whether you have one bill or several bills. But this question of the four powers that I mentioned, I just repeat, are on the table. They are on the table before the Federal Reserve Board and you cannot evade that. Decisions are going to be made in different ways before other regulatory authorities. Things are happening in that area and I don't think the Congress can throw up its hands and say "let it go as it will. You will get a crazy result, because you can't get a sensible result under present law. I think that's clear. You're going to get results, but they are not going to be sensible. So I think Congress must act in this area.

Senator **Dixon**. Well, my recollection—and I may be in error about this and someone on the committee may correct me—I don't think we even passed a bill including all the powers you have suggested. Perhaps the Chair would want to enlighten me. We didn't permit authorization of mutual funds.

The **Chairman**. We passed legislation out of the Senate by a 89 to 5 vote including all except one power.

Mr. **Volcker**. I think that is correct. Mutual funds were not included.

Senator **Dixon**. The point I make is that even this committee, which was more accommodating to your point of view in the Senate generally than the House didn't agree with all those powers.

Mr. **Volcker**. Well, look, there's room for improvement. You can argue about one power. I'm 75 percent or more better off than I am without anything. In fact, that is the power which is not before us now for a decision, as a matter of fact. But I'm 75 percent better off; I think the country would be about 95 percent better off.

The **Chairman**. Senator Gramm.

THIRD WORLD DEBT

Senator **Gramm**. Thank you, Mr. Chairman.

Chairman Volcker, I want to address a problem about Third World debt and I think that problems exist here from a lot of viewpoints. One is equity in terms of how we are treating other borrowers. I think a second part of it is the security of the system and ultimately a third part the dictation of American policy by the debt situation.

And I would like to pose the question this way: Today if the Comptroller of the Currency does an audit of a bank and that bank is holding Pemex paper, that paper is valued at par basically with IBM paper. Now we know that's a fiction. On the other hand, in auditing a bank in Houston that's holding real estate where there is a sheriff that can and will go out and repossess the property and some experience on the value of the property, we may force that property to be written off—certainly we're going to classify it under current circumstances of depressed market conditions.

I think it's desirable from the point of view of the financial system and the foreign policy of the United States to have foreign debt valued on the balance sheets of our financial institutions at market. On the other hand, we have perpetuated a fiction for so long that these assets were valued at par, that tomorrow to go out and value them at market value—I understand that there's a lot of Mexican paper, for example, on the secondary market circulating at about 59 cents on the dollar. To do that puts us in an untenable situation. So we perpetuate a fiction because the reality is so much worse than the fiction that we can't admit it.

Now what would you think of a bill or an amendment to a bill that would say the following thing: That, No. 1, the regulators have to value foreign debt at market estimate, except that you have a schedule for writing it down to market. That schedule might be that if the value of the asset were zero then it would be written off in 10 equal parts over 10 years or if it were 50 percent on the dollar it would be written down in 10 equal parts to 50 cents.

It seems to me that you could still get people out in the countryside saying that's not fair, you're treating domestic assets differently. On the other hand, the only way you're going to break the fiction is to have some orderly process of doing it.

It seems to me if we did that we would also really encourage a secondary market. A lot of this Third World debt would start to trade at a discount. You would have people who would specialize in collections. Some would be collected, some wouldn't be collected. A lot would be written off. Ten years from now the problem would have been absorbed by the system, in my opinion.

What do you think of a proposal like that?

Mr. **Volcker**. Well, if I use two words, I guess not much. We have some disagreement. The premise of your comments is that bank assets should be valued at market. That has not been the tradition in any area, and it's very difficult for me to see how a banking system would work effectively if you were going to revalue all our assets from Treasury securities to foreign loans every time the market changed in value. It would give a very unstable looking asset base.

The conception is that you obviously look at these assets and determine whether it is reasonable that they will be serviced and paid off over a period of time.

Senator GRAMM. Well, now let me just inject a second question here. Looking at Third World debt held by American banks and looking at their valuation in the audit process, do you believe it is reasonable to expect that they will be serviced and paid off over time on the basis of par?

Mr. VOLCKER. Well, if they're not being serviced they are marked down. I think they are being serviced now, the great bulk of them, in the major countries involved and I certainly look toward the period when more normal market processes will be restored and there will be more flexibility in this area. I don't think it's realistic to say that those countries are going to be able to repay the debt any more than the U.S. Government is repaying its debt or most large companies are not increasing their debt over a period of time.

The question is whether they can be serviced, whether in relative proportion they can be reduced over time, which is certainly happening, and whether you will return to a situation where they can finance more normally. That is the entire objective of the exercise.

Senator GRAMM. Well, it seems to me, Mr. Chairman—and we agree on much, but we certainly disagree on this——

Mr. VOLCKER. We apparently have a disagreement on this.

Senator GRAMM. But I can see experiences all over my State which I'm familiar with where people are in fact servicing their debt but because of the evaluation of the assets that secures the loan banks are being forced to write those loans off.

Mr. VOLCKER. Well, you may find instances where a loan—I wouldn't say written off if they're servicing the debt—is classified. Some of these foreign loans are classified. You may find encouragement for reserving and I would like to see more reserving in American banks against foreign loans and other loans. Reserving has been increasing. So I don't have any disagreement in that respect. But you said should they be written down across the board in relation to some value in the limited market that exists for them at the moment. I say that is not the principle of bank accounting generally and I don't think it's a direction we want to go in terms of bank accounting. You will have banks unable in practice then to make loans of any maturity, because they would constantly be frightened that the market value is going to change and that would affect their current earnings and current capital position in a way that I think would be deleterious to what banking is all about.

Banking is taking in short-term funds and transforming them into somewhat different maturities and a variety of credits. I don't think that process is aided and abetted by marking the whole balance sheet to market every quarter.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Chairman Volcker, you mentioned in your statement that banks be allowed to sell securities if appropriate safeguards are developed.

What would those safeguards be, in your opinion?

SAFEGUARDS FOR SELLING SECURITIES

Mr. **Volcker**. I think you would want certain safeguards against the possibility of self-dealing and conflicts of interest. We have, for instance, in approving our commercial paper operations for banks, a series of three or four procedures that they must follow and prohibitions as to the interrelationship between those operations and their bank lending operations.

Senator **Shelby**. As far as a date on grandfathering, which was brought up by one of the members of the committee earlier, if you go back to when you say somebody warned or the Board warned these people—isn't that punitive in nature? That's what you're really getting at, isn't it?

Mr. **Volcker**. I have no definite proposal upon grandfathering. The point I would make is that these operations are not very large now. In total there are only 13 nonbank banks owned by commercial firms with total assets, if I recall correctly, of something like $1.7 billion, half of which is one company.

The point I would make is that if you don't act upon this problem promptly, these questions of grandfathering and fairness become more severe, not less. And because the Congress did not act some years ago when this problem was negligible it has now become more difficult than it was. But if you really allow this thing to avalanche, then you've got an impossible problem.

Of course, that's what the other side wants. Those people don't want you to act so that the thing proceeds to the point where they can say, "Look, you've got a fait accompli. There's nothing you can do about us. The horse is out of the barn." That is precisely what the argument is here.

Senator **Shelby**. But if you redefine what a bank is—and that's what we're really going to talk about I suppose in this committee—there's got to be some blurring there. The market forces have gotten so far out—maybe they shouldn't have—you can argue that both ways, but there are forces out there that are working and how are we going to legislatively deal with it? That's the issue before the committee and the Congress, isn't it?

Mr. **Volcker**. Right at the margin there will always be some blurring and some fuzziness about what's commerce and what's finance or what's finance and what's banking, and obviously some decisions have to be made at the margin. Presumably they are going to be delegated to a regulatory authority. We administer the Bank Holding Company Act, but those are relatively trivial questions at the margin. I don't think there's any doubt about the basic issues.

Senator **Shelby**. Dr. Volcker, you mentioned in your testimony that—this isn't your words but perhaps mine—that you weren't really impressed with what a lot of the countries have done where they have really gone in, like the Japanese, and the Germans and so forth, as far as the integration of their banking system and commerce.

Mr. **Volcker**. Let me just be clear on what I'm saying. The old Japanese banking system was totally integrated and the conventional wisdom applied by American occupational authorities and others was that that was awful, that Zaibatsu system. It is not integrated now except informally. There may be a lot of informal integration.

Senator **Shelby**. What about the German system?

Mr. **Volcker**. The German system is somewhat integrated in one direction. Big banks or maybe small banks own sizable chunks of some industrial concerns. The interesting thing about that is—it's been true for years—it has become a matter of considerable controversy in Germany and you have various inquiries in Germany that say, "Gee, this is a bad idea; we ought to cut back on this." This will become an active legislative issue in Germany, going precisely in the other direction.

I can remember when I was in the Treasury about 15 years ago, we used to write tomes about how noncompetitive, archaic, inflexible, and concentrated the German banking system and the German financial system was. With all these linkages between commerce and business and with the concentration that it had, the market was not developing in a free, full competitive way. That is now what some Germans are saying and there may be some change. I'm astonished now that 15 years later anybody would look to the German banking system as the model of a modern Major General in this area.

Senator **Shelby**. Thank you, Mr. Chairman.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

Mr. Chairman, in my opening statement I mentioned to you that I feel this is a time we're going to legislate or the marketplace is going to legislate. How do you feel about that?

THE MARKET IS LEGISLATING

Mr. **Volcker**. The market is legislating and you're not saying much about it. And that's my concern, because I don't think the market, for all its virtues on some of these fundamental issues of public policy, is the proper judiciary body for determining what kind of a banking system we have down the road.

Senator **Hecht**. Well, we're taking the Band-Aid approach which you disagree with.

Mr. **Volcker**. Well, you're taking the Band-Aid approach. I think if you take the Band-Aid approach that I am supporting here, you would have set one important marker and then you ought to proceed. It's going to take more time dealing with what I would think of as comprehensive banking and financial services legislation.

But what I'm urging you to do is lay down a marker as part of your present legislative proposals and then all these other very difficult, complex issues, can be debated, including precisely where to draw the margin and certainly what kind of financial services bank holding companies ought to be engaged. That's going to take some time. Meanwhile, I think you ought to lay down the one marker so that that debate can proceed in a known framework.

Senator **Hecht**. I'm sorry. I didn't hear. Explain what the marker is.

Mr. **Volcker**. The nonbank issue, or translated, banking-commerce issue. Do you want combinations of banking and commerce or don't you?

Senator HECHT. And that's the issue we have to address?

Mr. VOLCKER. That's the marker issue which I think you must address right now.

Senator HECHT. Unfortunately, we have been spending too much time on determining what banks should charge on credit cards, the amount of time for check processing, and my own opinion is, this is a management process and we should not be legislating that. The marketplace will work that out.

How do you feel about that?

Mr. VOLCKER. Well, I certainly think you're dealing with one very important issue, or series of important issues. Those issues have much less or very little importance in shaping the nature of the banking system over time. In that sense they are less urgent. But I do think on this one issue of check holds—which has attracted a lot of attention—my sense is that a consensus has developed that this is the time to act. And I would support that. But I don't think it has the same importance in terms of the nature of the banking system down the road. I wouldn't suggest that for a moment.

Senator HECHT. You are very involved in the safety and soundness of banks, so I'm going to shift gears and get your comments on the tax bill last year as related to banking, especially the loan loss reserves. How do you feel about that?

Mr. VOLCKER. Well, I was not very happy to see that particular provision changed because I think there are particular pressures on the banking system at the moment in terms of credit quality. But even looking at it over time, I think a very reasonable case could be made—and I would support that case—that given the nature of the banking business, they ought to be encouraged to build reasonable sized loan loss provisions. But that position was not accepted by the Congress.

Senator HECHT. I could not agree with you more, but should we attempt—in safety and soundness, should we attempt to remedy that because I think that provision could have a lot of ramifications for some of the 14,500 commercial banks in America today.

Mr. VOLCKER. Well, much as I dislike it, I don't think that is a matter of the same urgency. At present, many of the banks are in a position where they are reserving. That doesn't attract any special tax benefits anyway, even under the old law, because they would have exceeded the amount that would have been tax sheltered. So that circumstance—I wish the law didn't go that way—makes it less critical as a matter of timing that that decision be reviewed right now.

Senator HECHT. Thank you very much.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Chairman Volcker, welcome. It's good to see you once again before the committee in good humor and fine fettle. Let me ask you a question about nonbank banks.

Do you think the nonbank bank issue is out of the barn now?

Mr. VOLCKER. No.

Senator SASSER. You do not think it's out of the barn?

Mr. VOLCKER. Some people would like to convince you of that.

Senator **Sasser**. You think at least if it's out of the barn it's not so far out that we can't put a halter on it and get it back in the barn?

Mr. **Volcker**. Thirteen companies with $1.7 billion of assets is not my interpretation of out of the barn.

Senator **Sasser**. Well, you indicate in your testimony that the long-standing policy of maintaining a basic separation of commerce and banking is being eroded and that the process needs to be halted before serious damage is done to our economy and to our financial structure.

Now while maintaining that, you also suggest that commercial banks be given what some would say is a wide array of new powers and I assume this is an effort to make them more competitive with nonbank banks. Would that be the rationale for that?

BROADER RANGES OF SERVICES FOR BANKS

Mr. **Volcker**. Not with nonbank banks. I think it enables them to provide a broader range of services within the general framework of financial services and this is not a new issue. We have supported those powers for years and we don't see that they present any real problem from a safety and soundness or conflict of interest viewpoint, problems that are not manageable. They would be regulated and supervised to a degree. It just does not raise the same kind of issues, that it is a minimal part of the logic of any expansion of bank holding company powers.

Senator **Sasser**. Well, what is wrong with dealing with this problem of the overlap developing between commerce and banking, of dealing with the problem by simply saying that there's not going to be any further creation of new powers for banks and at the same time there is not going to be any further creation or growth of nonbank banks? That is, simply saying that no new powers and if the horse is not out of the barn on nonbank banks no nonbank banks, or no new ones?

Mr. **Volcker**. I think they are different issues. When you say no new powers for banks or bank holding companies, the new powers that we're talking about are in the general financial area and do not violate, in my judgment, proscription of combination of banking and commerce. And I think you need some progress in that direction. There are a lot of nonbank banks or more nonbank banks that are being created by financial services concerns than by commercial concerns. Whether they make sense over a period of time—take out the "non" in front of bank—depends I think upon your judgment about what range of financial services should be provided by a bank holding company or by any holding company, including a bank.

That is an issue that I think you want to debate and resolve as part of what I would think of as more comprehensive legislation. That is the important issue. But if you decide that bank holding companies can do these securities powers, and let's say do corporate underwriting, then there's nothing the matter with an investment house owning a bank. It would work reciprocally. But neither of those involve the issue of commerce and banking. I'm taking commerce as nonfinancial business, the borrower so to speak, not the intermediaries but the borrowers.

Senator **Sasser**. Well, let me shift gears for a moment, Mr. Chairman, and ask you this. This morning the Washington Post reported that several of the 12 regional Federal Home Loan Bank Board banks are considering withholding loans and other assistance to ailing savings and loan institutions and there are about 272 ailing S&L's, according to this report that are losing over $6 million a day and it's very doubtful that these S&L's could survive very long if this loan window is closed to them.

Is this a wise move on the part of these regional banks or is this not going to further erode public confidence in the general solvency of the thrift industry and some overlap then in the public confidence in the whole general financial structure?

Mr. **Volcker**. I'm sure that Mr. Gray will want to address himself more precisely to this question.

Senator **Sasser**. I'm going to ask him that same question.

Mr. **Volcker**. But it is very much tied up with this question of injecting some capital liquidity into the FSLIC and that is what the FSLIC recapitalization proposal is designed to do. It would have, my understanding is, the effect of dealing with that very problem that you cite; and that is why that is a matter of urgency—to do something to support the FSLIC. There's no other practical proposal on the table.

The **Chairman**. Senator Dodd.

Senator **Sasser**. I was going to say my time has expired, Mr. Chairman. I was going to try to sneak in one more question.

Senator **Dodd**. Go ahead. I'll be glad to yield.

Senator **Sasser**. Well, I thank my colleague from Connecticut.

Mr. Chairman, one thing that's troubling to me is this. If there is further deregulation in the financial services industry along the lines that you have suggested—new powers for banks—what do you see as the future for the small independent community bank? Those independent banks have been very, very important in the economic development of many of the more rural areas of this country.

Mr. **Volcker**. I don't see any real adverse implications for them. Depending on what power you're talking about, they are interested in some of these powers. Obviously, their emphasis in powers will differ from the emphases that the largest banks might have.

Senator **Sasser**. Well, they want to sell insurance. That's about all they could do.

Mr. **Volcker**. Right. Or real estate to name another. Some of them are interested in real estate development which we are dealing with in another context. But they face competition to the extent it affects them at all from present underwriters of mortgage-backed bonds or mutual funds. Many regional banks I think would be interested in participating. One of the clear benefits of municipal revenue bonds would be that banks in those particular areas could deal with their local State authorities, their county or municipal authorities in that area, as they already do in general obligation bonds.

Senator **Sasser**. Thank you, and I thank my colleague from Connecticut.

The Chairman. Senator Dodd.

CHECK HOLD LEGISLATION

Senator Dodd. Mr. Chairman, just very briefly, I won't take a lot of time. You've been over an awful lot of this ground already with many of us. I want to commend you on your statement on the last two or three pages on the check hold legislation—your prepared statement anyway. I find it most supportive and positive language on that issue and I thank you for that.

In fact, on February 5, Mr. Chairman, I think we are going to have hearings in the Consumer Affairs Subcommittee on the issue of check hold legislation and, Chairman Volcker, I would just ask today formally if we could get your comment on the bill. We introduced a bill yesterday.

Mr. Volcker. I understand our staffs have already had some contact and we are prepared to be as helpful as we can.

Senator Dodd. Terrific. I think what you suggested here is very supportive and helpful. I don't see any difficulty in working out something that you would find agreeable.

Second, I come back to this nonbank bank issue and we have to deal with the practicalities up here. I appreciate where you're coming from on it. It seems to me we're caught between the proverbial rock and hard place. If we take a grandfather date, which is what we're going to have to do if we deal with this, if it's too close to today's date not only has the barn door been closed too late when it comes to the cows but almost every other farm animal you could think of I think is out. If we go to a date that's further back, 1 year ago or 8 months ago, you create a real equity problem it seems to me.

I wonder if you have any other suggestions other than this grandfather date? Could we look at something like the consumer bank issue? Are there other ways of dealing with this issue which would satisfy your concerns short of dealing with what seems to me inevitably is going to be an equity issue?

Mr. Volcker. I don't know of any other approach.

The Chairman. Would the Senator from Connecticut yield on that?

Senator Dodd. Yes.

The Chairman. We can reduce the powers of the nonbank banks, and that's something we very definitely have in mind.

Senator Dodd. What does the Chairman think of that?

Mr. Volcker. I would say generally, from where I sit, I don't think you're between a rock and a hard place. You're between a rock and a soft place. The rock is the policy you want to follow and this grandfathering issue is very complicated, but I think it has to be kept in perspective.

This thing is in embryonic form. What I'm worried about is the implications if you don't do something. But you are dealing with a very poorly developed instrument that, at this point, is not critical to the fortunes or heavily integrated into the fortunes of the pyramid or the rest of their operations. They are brand new and small with possibly one exception. What you are faced with is a barrage of lobbying to keep this open as far as possible so that they can make the argument more reasonably that they are making. And every day you delay, that place that I consider now a fairly soft place does become harder.

Senator Dodd. Last, you've commented on this already but I would—there's been it seems a working—and you've always been very careful to suggest that political decisions on how we decide to frame legislation is something we have to grapple with and that's something you've been gracious enough to comment on in the past but just the question of the five issues before us—we went through a terrible time last year where, as you point out correctly, all are emergency issues—and I agree with you on that. Some it seems to me have a greater sense of emergency than others.

In the area of the country where my colleague from Texas comes from, they've got some very pressing, serious problems that should have been dealt with a year ago.

And my concern is we failed to deal with that, it seems to me, because we tried to lump them together. I appreciate what you're driving at here. I think there's a greater possibility—I would just share with you—a greater possibility of getting to all of these five issues if we dealt with them politically a bit differently than we have in the past and that is to deal with the ones we all know we can deal with right away.

The ones that I think there's more controversy up here on, rightly or wrongly, I think we have a better chance of dealing with than if we try to tie them together with so-called more attractive or favorable pieces of legislation that might enjoy support on the House side. That's just this member's observation, but it seems to me that approach has failed. I don't see any great reason for it to be changing politically.

Mr. Volcker. I would leave that to you, but I would just repeat that if that reduced to a formula for doing nothing—let's say, on the powers of nonbank banks—the power thing is just not going to wait. It's just a question of whether you're going to get a sensible answer or an arbitrary, anomalous, self-defeating kind of answer. That's the only issue at stake. On the nonbank bank issue, for the very reasons you've just been explaining yourself, I think you need to lay down the marker.

Senator Dodd. Thank you, Mr. Chairman.

The Chairman. Senator Riegle.

FALLING VALUE OF THE DOLLAR

Senator Riegle. Mr. Chairman, you've covered a lot of this and I'm going to have a number of questions for the record, but I want to raise a different topic with you today and that has to do with the speed and the distance that the dollar has come down in recent days. We're heavily focused in the Finance Committee and in other committees now on the trade issue and the competitiveness issue and there are a number of people who feel that the way to solve the trade problem, at least in substantial measure, is to drive down or let the value of the dollar go down and to keep it going down until we start to see a major turn in the trade deficit.

I think if you look at last year when the dollar dropped about 40 percent against the yen and the trade deficit with Japan actually went up, that there are a lot of reasons why that is so, but it calls into question I think just the basic nature of that strategy.

But my question today is this: If that view prevails and the dollar does continue to go down as sharply as it has gone down in recent weeks here, isn't there a point at which we start to experience some risks? Even if we start to get some improvement on the trade situation because of currency differential changes at least with some countries, is there a point at which and do we have to consider the possibility that new risks start to come forward with a dollar that just keeps going down? I really think we have to understand the nature of those kinds of risks if they're there and I would like to hear you address that.

Mr. VOLCKER. I don't think there's any question about that. I don't think it's a sensible policy just to say you drive the dollar down forever until you see improvement in trade. In the short run, driving down the dollar in numerical trade because the price of imports goes up may deteriorate the trade balance. I think it is a matter of judgment as to when the dollar has gone down enough, but there are obviously dangers in continuing devaluation. That cannot be a policy in and of itself.

You've got to worry about the productivity and efficiency of the economy. That's fundamental. You've got to worry about what's going on and whether other countries are adjusting. You've got to worry about the budget deficit which requires a large inflow of foreign capital support which is one of the things placed in jeopardy at some point by a decline in the dollar.

And I might say about these things, I don't think I have any disagreement with the administration officials I talk to. I'm not making any big statement here of difference. I think there would be a consensus on those points.

Senator RIEGLE. There would be a consensus that if the dollar were to just continue to fall sharply that you start to get negative effects that outweigh any advantages?

Mr. VOLCKER. If nothing else is done, there are real risks in that course, yes.

Senator RIEGLE. But it seems to me that the other things you talk about are long-term things. We can't necessarily address all the issues of improving our own productivity and performance and everything that bears on that overnight and we need to do it as fast as we can, but many of those things take time.

Mr. VOLCKER. They do take time and I think there are some quite promising developments on that score. I think we have seen certainly better restraint on costs in industry. It's been a rather remarkable performance during these years of expansion.

Senator RIEGLE. Let me just ask you this. Some say that just in terms of how much lower the dollar ought to go—and there are some people who are advocates that it go lower and that it be helped to go lower—are saying that if it were to go down another 10 to 15 percent it would make a material net improvement in our overall situation, starting with the trade area.

Mr. VOLCKER. I don't think I want to get into this in any detail. I expressed myself some time ago that under certain assumptions, including growing markets abroad, that those markets are open to us, that we pay attention to enhancing productivity in industry, that we particularly may pay attention and succeed in maintaining reasonable price stability—under those kinds of assumptions I think we are reasonably close to what should be a competitive level.

Senator RIEGLE. Close now?

Mr. VOLCKER. Well, I said that a few months ago and I don't see any reason to change that opinion.

Senator RIEGLE. Well, some things have happened since a few months ago.

Mr. VOLCKER. That's true. Something has happened with respect to the European currencies. The yen is almost at exactly the same level as it was when I made that statement.

Senator RIEGLE. But ours has gone down substantially since that time.

Mr. VOLCKER. Not against the yen. It went up and then down.

Senator RIEGLE. Yes.

Mr. VOLCKER. It's gone down against the European currencies but these are broad judgments. They are not down to the last 5 yen or the last 5 pfennigs or close to it. It's a very broad judgment.

Senator RIEGLE. Well, I guess my question is this—in your view, do we seem to be close now to the level that may be a sensible level, taking everything into account, or is there major additional lowering that can go on here where we can come out ahead?

Mr. VOLCKER. I can only repeat what I said before. I think that the implication is there are things that we have to do here and things that have to be done in other countries to support stability in exchange rates in a broad sense.

Senator RIEGLE. So I take it then that you feel pretty comfortable about it at the moment.

Mr. VOLCKER. I think there are lots of problems that we must keep working at—maintaining stability, maintaining productivity and efficiency. I don't feel at all comfortable about the budget deficit. I don't feel comfortable about the rate of growth abroad. So some things I feel encouraged about and other things I don't.

Senator RIEGLE. But the fall in the dollar is something that you are—that that's not unsettling to you at this point?

Mr. VOLCKER. Oh, I always worry about it.

The CHAIRMAN. Unfortunately, time is up. There's been excellent questioning, of course, by all members of the committee. I want to thank you very, very much, Chairman Volcker. We have Secretary Gould who has been waiting and he has a deadline, so we're going to have to cut off the questioning at this point. Again, thank you very, very much, Chairman Volcker.

Under Secretary of the Treasury George Gould is our next witness. We will keep the record open if members want to submit questions for Chairman Volcker.

Mr. Gould, I announced before and Chairman Volcker stuck pretty much to it that the oral statement will be 10 minutes and we will include in the record your complete statement and then question you for 5 minutes each. Go right ahead, sir.

STATEMENT OF GEORGE D. GOULD, UNDER SECRETARY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. GOULD. Mr. Chairman and members of the committee: I am delighted to have this opportunity to testify on the challenges facing our financial services industry.

We are greatly encouraged by your early hearings, particularly because there is an urgent need to solve immediate safety and soundness concerns.

RECAPITALIZING FSLIC

Recapitalizing the FSLIC is our top priority. For reasons I have outlined in my testimony, we think the need is pressing and the time to act is now.

When that essential safety and soundness issue can be put behind us, we stand ready to work closely with you on the other competitive and consumer issues I discuss in my testimony.

We believe a comprehensive restructuring of our financial services industry is overdue. As Treasury Secretary James Baker stated last week, "America needs to reposition itself on the leading edge of the financial services world."

A little over one year ago, Congress asked us to devise a plan to come to the FSLIC's rescue. We responded early in 1986 because we are no less concerned about the safety and soundness of the public's insured savings.

The problems of the thrift industry and FSLIC's dwindling reserves are well-known with highlights contained in my written statement. With that background and working with the valuable assistance of the Federal Home Loan Bank Board, the Federal Home Loan banks, and members of the industry, we devised a plan which is based on two fundamental points.

First, it is truly a self-help plan on the part of the industry. No taxpayer money or Government guarantees are involved. Taxpayers will not be required to bail out an industry that with some measure of sacrifice over time can help itself and where the healthy institutions are enjoying record levels of profit.

Second, our recap plan has sufficient resources available when necessary to meet the real problems which exist today. These are not theoretical or prospective problems. Rather, they are an accumulation of the present and the past and involve safety and soundness for depositors with almost $900 billion in savings. I am pleased to note that our plan has been endorsed again by many responsible people in the thrift industry, including presidents of the Federal Home Loan banks, the National Council of Savings, and the New England League.

As you know, it was also passed by both Houses of Congress last year.

While some people may think our plan is complex, the concept really is quite simple. Money is needed now and over the next few years in an amount well beyond that which is available either from FSLIC's existing resources or from what it is reasonable to expect from industry assessments over the same period of time.

Thus, money is borrowed from nongovernmental sources, invested in FSLIC, used to resolve problems, and then is paid back over time. Any homebuyer who needs a mortgage understands that concept well.

The actual financial structure we have used to accomplish the concept is really just detail but detail that works! As you know, our plan also meets CBO requirements, with GAO concurring, to be considered an offsetting collection rather than a Federal borrowing for budgetary purposes.

You will hear testimony tomorrow about an alternative plan by the U.S. League. Let me just take a moment to comment on what we consider to be a largely pay as you go approach.

If you start with just the simple arithmetic of their financing scheme, you will see that the numbers don't add up to meet what we consider to be a responsible level of resources needed for FSLIC's existing case load. Also, the League's own worksheets reveal that it is a far less efficient way to raise funds for FSLIC. Indeed, even to get as far as they go, there has been a substantial shift in responsibility from the industry to the Federal Home Loan Bank Board system, a Government-sponsored enterprise and an agency borrower with a $4 billion line of credit from the U.S. Treasury.

Their plan, like a bad check, ought to be rejected by Congress due to insufficient funds. I would be happy to comment further on their plan during the question and answer period.

In the final analysis, no one in Government wants to see depositors standing in line like they did in Ohio and Maryland. We, therefore, urge you to pass our recapitalization bill quickly and cleanly.

EXPANDED POWER FOR FEDERAL BANK REGULATORS

Mr. Chairman, you have also asked us to comment on the regulators' bill. In my written testimony I have indicated that we are supportive of expanded authority for the Federal bank regulators to handle problem institutions with a minimum of disruption to consumers and to communities.

The regulators are best suited to discuss specifics, particularly in light of recent actions taken at the State level.

Let me now turn briefly to the competitive issues that confront us within the financial services industry.

Treasury has taken the position that the Norman Rockwell picture of financial services that some would like to paint is a thing of the past. Families all across America are seeking and will continue to pursue a financial system that serves their economic needs and meets their requirements for safety, convenience, and diversification.

We have also warned that protectionist models of repairing crumbling walls of financial oligopolies simply will not work. Consumer tastes, technology in the marketplace, particularly the highly competitive global financial marketplace, will quite frankly move beyond these protectionist efforts.

We are encouraged that new ideas are springing forth, for example, about more expansive financial service holding companies where insured deposits, the payment system, and the connections to owners would be regulated prudently in a common fashion and where a broad list of services would be available to consumers and to businesses alike.

MAYFLOWER GROUP

The six leading bank trade associations have announced a joint effort on this subject. The so-called Mayflower Group is working in the same direction and has just issued a statement of forward-looking principles, that we heartily endorse, by which to measure any new financial world Congress might create.

We have said before that in the context of providing expanded consumer benefits we see little wrong with the concept of consumer banks. In examining the arguments of those who oppose these special institutions, we find they break down into two basic thrusts.

The first is safety and soundness. We do not believe that consumer banks undermine the integrity of our financial system. We are not aware of any such institution which has been a problem to either the Federal Deposit Insurance System or to the integrity of the Nation's payment system.

Also, it should be remembered that these consumer banks or nonbank banks are regulated, supervised, and examined like any other bank.

The second thrust is competitive inequity. Some argue that owners of consumer banks may enjoy some competitive advantages. If there is actually an equity problem, we believe it can best be resolved by allowing more freedom to traditional banks, not by pulling back the procompetitive aspects of nonbank banks to the lowest common denominator.

In our view, it is unnecessary to prohibit the creation of these new institutions when their benefits to the public can be substantial and identifiable problems can be managed adequately by regulation. Obviously, consumer banks are meeting individuals' financial requirements and serving consumers' investment and credit needs well. If they didn't, they wouldn't exist for long.

On this note I want to stress the administration's strong support for consumer safeguards in a modern financial world. Consumers ought to have accurate, timely and meaningful information to select the product or service which is most beneficial for their needs.

We also firmly believe that all consumers ought to have access to their funds as soon as humanly and technologically possible.

In conclusion, we are advocating that instead of turning back the clock, we believe Government should promote a freer, more competitive financial services marketplace complete with appropriate protections, proper supervision, and meaningful disclosure.

Nor is this only a domestic issue, for this country's international competitiveness is not limited merely to manufactured goods. In our judgment, we will all miss an opportunity, an important one, if legislation is limited to a dose of reregulation perhaps with a few product opportunities for bank holding companies, and then assert that all is well.

NEED FOR COMPREHENSIVE LEGISLATION

Substantial changes in the financial world continue. Commercial banking institutions have lost significant portions of their traditional intermediation role. A decision to do nothing about a more comprehensive legislative reform of old laws is the equivalent of a conscious decision to endanger the role of American banks in our domestic economy and to risk the further loss of competitiveness abroad.

We would look forward to addressing such issues with you, but once again urge strongly the FSLIC recapitalization as the first stage of your legislative action.

Thank you for having me and I stand ready to answer whatever questions I can.

[The complete prepared statement follows:]

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Testimony of the Honorable
George D. Gould
Under Secretary for Finance
U.S. Department of the Treasury
Before the
Committee on Banking, Housing and Urban Affairs

Mr. Chairman, Senator Garn, and Members of the Committee:

I am delighted to have the opportunity to testify before you today on the challenges facing our financial services industry. I am greatly encouraged by your early hearings. They are an indication that this Committee senses the urgent need to solve immediate safety and soundness concerns, particularly those affecting the thrift industry and the FSLIC.

In order to stress how strongly we believe that FSLIC recapitalization is necessary by early spring, we asked the bipartisan leadership of the Senate and House Banking Committees to reintroduce our proposed bill on the day the new Congress convened. It is the same basic plan that passed both houses of Congress last year. Given the immediacy of the problem I will describe, we cannot afford delay.

As soon as the FSLIC recap bill becomes law, we in the Administration stand ready to work closely with you to develop comprehensive legislation that will restructure our financial services industry. As Treasury Secretary James Baker stated just last week:

> It's time for a change. America needs to reassert itself on the leading edge of the financial services world. We've got the ability. We've got the motivation to do it. And we certainly have good reason to do it if we want to be internationally competitive.

But Secretary Baker also added this one important caveat:

> If Congress applies the "protectionist" model by trying to repair the crumbling walls of financial oligopolies, the marketplace, technology, and consumer tastes will move beyond. The victim would be one more U. S. industry that would not -- or in this case could not -- evolve to meet the competition.

Our goals for any comprehensive legislative package include:

1. Strengthening the safety and soundness of our financial system so that the public will continue to have confidence in the stability of our financial institutions;
2. Promoting consumer benefits by providing the best and most efficient financial services at the lowest price; this assumes consumers have full access to timely, accurate and understandable information to make informed judgments; and
3. Modernizing our laws to permit U.S. financial institutions to compete fairly with one another and with foreign firms in product and geographic markets, both at home and abroad.

I. The FSLIC Issues

The Administration is committed to maintaining a safe and sound financial system -- especially where insured deposits are involved. The safety of consumers' insured savings is a critical issue for all Americans.

Size of the Problem

The problems affecting roughly 20 percent of the savings and loan industry are well known. I have testified on them extensively and consequently will focus my remarks today on the Federal Savings and Loan Insurance Corporation (FSLIC).

The Federal Home Loan Bank Board (FHLBB) estimates that the FSLIC will need about $20 billion to resolve the problems of institutions in the FSLIC caseload, those considered significant supervisory cases and other anticipated cases. However, the FSLIC's total reserves at the end of December 1986 were only slightly over $3 billion ($800 million of which is in FSLIC's secondary reserve and is carried as an asset on the books of the industry) and could fall rapidly to under $2 billion by the end of February 1987. When the Government Accounting Office (GAO) audits the FSLIC's books, it may require the FSLIC to add to its reserves for losses and thus reduce reserves even further, quite possibly to a negative position. To obtain a "clean" accounting opinion for the year-end 1985 financial statement, the FSLIC was required to increase its provision for loss contingencies by $1.6 billion.

In 1987, the FSLIC expects to receive about $2.4 billion in total income, which includes regular premiums, special premiums, investment and other income. This sum fails even to cover the operating losses of about $2.6 billion per year piling up on FSLIC's caseload -- to say nothing of resolving some of these insolvent S&Ls. Delaying the resolution of problem institutions will significantly increase the FSLIC's ultimate cost.

In addition, the reduced size of the FSLIC reserves is already causing the FHL Banks to voice concern over their ability to accept the FSLIC's guarantees of advances (loans) that the FHL Banks make to distressed institutions. The FSLIC has reported that the insolvent (but still open) institutions will be forced to more aggressively solicit new deposits which will raise not only *their* cost of funds -- and the ultimate resolution costs to the FSLIC -- but also raise the cost of deposits for *all* depository institutions in local markets and beyond.

Treasury's Three-Pronged Strategy

In previous testimony I recommended a three-pronged strategy to help the thrift industry and the FSLIC. We still support this plan, which I want to briefly summarize for you now.

First, we have stated that we need to strengthen the thrift industry as a whole. To do this we encouraged the FHLBB to set targets and create incentives for the industry to increase its capital, and concurrently, to halt the growth of the industry's problems through improved supervision. Last August the FHLBB adopted new standards for insured thrifts which phase-in higher capital requirements over time. The Board also has significantly increased the number and quality of examiners in an effort to improve supervision.

The second prong of our strategy was to lower the resolution cost that the FSLIC and the industry must pay by enhancing the franchise value of ailing thrifts and thus increasing the price acquirers are willing to pay for these thrifts. In the past year, the FHLBB has adopted regulations that increase the franchise value of insolvent thrifts by permitting acquiring savings and loans to expand into three additional states. More needs to be done. I will discuss this part of our strategy more fully later in my testimony.

Third, we called for increasing the FSLIC's resources so that it could handle a greater number of insolvent institutions in the next several years. The time to act is now. The low interest rate environment has enabled most of the industry to have high earnings. Every day we wait, FSLIC estimates its costs increase by $6 million. (A detailed description of the recapitalization plan is attached.)

The Treasury/FHLBB FSLIC Recapitalization Plan

In devising our plan to recapitalize the FSLIC, two simple requirements were uppermost in our minds.

First, the time-tested notion of self-help was vital. The taxpayer must not be called upon to bail out an industry that with some measure of sacrifice over time can help itself. After all, many thrifts have profited greatly from their franchise and they probably were paying too small an insurance premium in the past.

Second, the recapitalization plan must have enough resources available up front to meet the real problems we all recognize today. To this end the FHLBB, the Federal Home Loan Bank System, and the Treasury devised a unique industry-based plan that would enable the FSLIC to devote about $25 to $30 billion over 5 years to handling its sizeable load of problem cases, while in all likelihood being able to phase-out the special premium assessment over the same period.

I am pleased to note that our plan has been endorsed again by many responsible people in the thrift industry who share our concerns. We welcome the strong support of groups like the National Council of Savings Institutions and the New England League of Savings Institutions.

Briefly, under our plan the FHLBB would charter a Financing Corporation which would be capitalized with up to $3 billion of the FHL Bank System's surplus over five to six years.

The Financing Corporation then would borrow up to $15 billion by issuing long-term bonds over the five-to-six-year period as the funds were needed by FSLIC. It would assure payment of the bonds' principal by using up to $2.2 billion (of the $3 billion) of the FHL Banks' investment to purchase long-term, zero coupon instruments, which at maturity would equal the bonds' principal. (The remaining $800 million from the FHLBanks' investment would serve as a special "interest reserve" to ensure the phase-down of the special assessment even under adverse circumstances.) The interest on the bonds would be paid by the Financing Corporation through assessments. Each insured institution would pay in an amount not to exceed 1/12 of one percent of an institution's total deposits, unless the FHLBB determines an additional amount up to 1/8 of one percent of deposits is necessary. In other words, the Financing Corporation could have the authority to use all of the FSLIC's current premium and special assessment income. Any assessments made by the Financing Corporation would reduce FSLIC's assessment authority dollar-for-dollar.

The Financing Corporation would then invest the $15 billion it raises in nonvoting capital stock and nonredeemable capital certificates of the FSLIC.

The FSLIC would thus have available the $15 billion, the annual premium income in excess of interest costs (phased down over five years), income from investments, and reflows from the sale of assets acquired from resolving cases (or a total of $25 to $30 billion over 5 to 6 years) to resolve the problem cases.

Some members of the industry argue that the FSLIC could not efficiently use more than $1.8 to $2.0 billion in any one year to resolve problem institutions. This is not true. The FSLIC's case resolutions in 1986 cost about $3.0 billion. This money was used to resolve 51 cases with about $23.9 billion in assets. FSLIC could have done more if it weren't concerned about maintaining a cushion of reserves.

To assist in liquidating these assets at the highest price for the FSLIC, the FHLBB in November 1985 chartered the Federal Asset Disposition Association (FADA). The FADA is a nonprofit organization that has been responsible for disposing of the more complex and large properties the FSLIC has acquired from failed institutions. The FADA does not take title to any assets, but now has about $2.02 billion under its management.

The Treasury/FHLBB plan was carefully designed so that the money injected into the FSLIC would be an offsetting collection rather than a borrowing for budgetary purposes, so as to offset outlays for case resolutions. Therefore, our plan provides $15 billion of extra budget receipts (beyond assessment income) over 5 years.

Nearly one year ago, Congress asked us to provide a solution for the problem of declining FSLIC resources. We supplied a workable plan which is industry-based and gets the job done now. Our plan gets the money into FSLIC as needed. It phases out the special assessment, protects the integrity of the FHL Banks, and safeguards the interests of the FDIC members of the FHL Banks. We have presented a plan that makes good sense from a budgetary perspective.

In the final analysis, no one wants to see depositors standing in lines, like they did in Ohio and Maryland where state-chartered insurance funds were not equipped to meet the challenges arising from problem institutions. It is time for Congress to act.

For these reasons, we hope you will move this critically important legislation, which both houses of Congress passed on the last legislative day last year, quickly and cleanly through the new Congress, so that it can become law by this spring.

FSLIC can't wait.

Problems of Industry Alternatives

The U.S. League has recently devised a "pothole plan" for FSLIC: It would leave the FSLIC in a state of shock, shake up the Federal Home Loan Banks, and jolt the nation's depositors -- all because the League neglects timely repairs.

- The League's Plan provides insufficient funds.
    - The plan at best provides $5 billion. A close look at the plan reveals it would even condition raising this $5 billion on FSLIC's cash (liquidity) position, not its reserves (FSLIC's capital). But the FSLIC can have cash with zero or negative reserves (because liabilities exceed assets). What good is a plan that may not provide funds until after the public knows the FSLIC is out of reserves?
    - The longer the resolutions of insolvent thrifts are postponed, the greater the ultimate cost will be. The logic is straight-forward: If an insolvent thrift is suffering operating losses, systemic (FSLIC) losses are building.
- The plan is a "pray-as-you-go" plan: the longer the resolution of failing thrifts is postponed the greater the risk that interest rates will rise.
    - Higher interest rates would raise the FSLIC's resolution costs enormously. The cost of deposits would rise, increasing operating lossess and decreasing the value of some assets.
    - A GAO study in September 1986 found that a 2 percentage point rise in interest rates would cost the FSLIC an additional $7 billion in resolution costs over the next two years. And lower interest rates are not going to help S&L's with problems loans that are based on poor quality.
- The League's Plan may not even produce the $5 billion.
    - It is hard for new corporations to issue 20-year bonds. It gets even harder to sell 20 year zero coupon bonds because the investor has to wait 20 years before he gets one cent back. When the sources of repayment are as vague as the League proposes -- a share of the FHL Banks' earnings supplemented in some fashion from the industry -- the debt looks speculative at best.

  - In contrast, the Treasury/FHLBB plan issues regular bonds and can assure the bondholders' principal from day one by buying Treasury zero coupons.
  - Despite the speculative nature of the League's zero coupon bonds, it assumes an 8 percent interest rate. This is unrealistically low.
  - The League's plan places a vague (but likely very large) future burden on the industry to cover interest costs with extra assessments. (A higher borrowing rate than they have assumed would make these huge.) In contrast, the Treasury/FHLBB plan includes a clearly evident phase-down of the special assessment over 5 years, backed by an extra $800 million interest reserve cushion.

- The League's Plan is inefficient: It would raise less and cost more.
  - The League's own worksheets reveal that it would raise only 1/3 of the money for over 1/2 of the cost of the Treasury Plan.
  - The burden imposed on both the FHL Banks and the industry (with uncertain future assessments) by the League's inefficient venture would make it extremely hard or impossible to call on either to help, if FSLIC needs more than $5 billion (as we already know it does).

- The League Plan weakens the stability of the Bank System.
  - The plan draws from the FHL Banks an annual $275 million or 20 percent of earnings, whichever is larger, for 20 years.
  - The 20 percent of earnings is the statutory requirement for legal reserves, so for 20 years the FHL Banks couldn't build reserves that are there by law for safety and soundness.
  - If the FHL Banks were to get into trouble, they would have to cut into dividends to their members or, in the extreme, seek to draw on a conditional $4 billion line of credit with Treasury.
  - The plan would also demand more from the FHLBanks with FDIC-insured members (primarily in the Northeast, Mid Atlantic, and Far West) in contrast with the Treasury/FHLBB plan.

- The League's plan increases the real risk of a liquidity crisis at some institutions.

  - As stated earlier, the FHL Banks may find they can no longer accept the FSLIC's guarantee of advances (loans) made to trouble thrifts.

- In summary, the U.S. League's Plan raises too little money in an inefficient manner that puts long-term strains on the FHLBanks.

First, the League denied there was a problem. Then they killed the 1% recapitalization proposal. Now they have a phoney proposal to stop a real recapitalization of FSLIC. Finally, they try to hide behind assertions that FSLICs' problems are not really that bad and that there are not costs of delay.

In our view, it is high time to fulfill our joint responsibility to protect America's thrift depositors. I urge you to reject calls for further delay, more study, and toying with grand schemes that fall short of providing FSLIC with the necessary funds to carry out its insurance functions.

Some people in and out of government have suggested that the solution to FSLIC's funding problems is to merge the two federal deposit insurance funds. Let me assure this Committee that the Treasury Department has no hidden agenda to merge the funds.

It is true we have stated that failing substantial success to enact our FSLIC recap plan, the concept of merging FSLIC and FDIC comes ahead of using taxpayer money, which would be a last resort only to prevent systemic problems for depositors. It may be useful to clarify precisely what this merger would mean:

- There still would be two funds, not one commingled entity -- the merger would be at the regulatory level;
- money still would be needed up front and still would have to be borrowed -- FDIC's reserves would not be available (except possibly as a backstop for an FDIC guarantee of the "thrift fund" borrowings);
- the S&L industry still would not avoid the costs -- a premium differential is inevitable; and
- debate and negotiation would be time consuming and extremely difficult, contributing to uncertainty in the marketplace.

Encouraging the Flow of Private Capital into the Thrift Industry

Another part of reducing the long-term cost of solving the problem of failing thrifts is to encourage bank holding companies, financial services firms, and others to acquire them. The FHLBB has reported that the cost of merging failing or failed thrifts for 1981 to 1986 ranged between 4.2 percent of assets to 7.3 percent. Liquidation costs varied from 21.9 percent of assets in 1983 to 45.7

percent in 1986. The Federal Reserve Board (FRB) has moved cautiously in permitting bank holding companies to acquire insolvent thrifts, and the FRB's tandem restrictions on BHC's acquisitions of ailing thrifts are exceedingly stringent. When the FRB last May asked for public comment, we encouraged them to review carefully their restrictions and liberalize them to attain more reasonable standards. We are still waiting for FRB action.

The FRB's regulatory separation between an acquired thrift and other subsidiaries is much greater than that between the BHC's bank and other subsidiaries. These rules are vestiges of acquisitions during an earlier era when statutory interest rate differentials were in place, and before interstate banking compacts took hold. In addition, "tandem" restrictions make thrift acquisitions exceedingly less attractive and strike a blow against consumers by prohibiting crossmarketing and other business connections that improve service and competition. Perhaps the FRB is in part waiting for signals from Congress with respect to the current usefulness of such restrictions.

The unitary thrift holding company is an example -- with over 20 years of proven history -- of how nonfinancial institutions have added capital to the industry by purchasing failing and non-failing thrifts.

We recognize that interindustry thrift acquisitions are a touchy subject, especially for some segments of the industry that wish to avoid competition. But the acquisition logic is straightforward and undeniable. The problem institutions have created real costs that the FSLIC, the industry, and the consumer must bear. A broader range of purchasers can help FSLIC lower these costs by reducing the costs of dispositions. And they can bring additional capital to an industry that needs it badly.

In summary, we urge Congress and the regulators to accommodate new acquirers of insolvent thrifts. If we are concerned about business ties, we should cope with them through regulation of affiliate transactions and conflicts of interest, not through prohibition of ownership.

The Regulator's Bill

Mr. Chairman, you asked me to present the Administration's position on the "regulators' bill." The Administration believes that the emergency acquisition provisions Congress authorized in 1982 were very beneficial -- by reducing costs for the insurance funds, helping to maintain financial services to communities, and assisting in securing the stability of the financial system. My prior statements on this issue have emphasized some of the benefits we believe would be served by a liberalization of the emergency acquisition provisions of the Garn-St Germain Act. We continue to support legislation which grants the regulators additional authority to handle problem institutions in an orderly, least cost fashion to prevent an undue disruption in the provision of financial services to consumers and their communities.

II. Competitive Issues and Financial Changes

As I have stated in the past, I believe that our deposit insurance system can be, over time, only as strong as the industry it insures. And our bank and thrift industries will remain financially healthy only if they are permitted to compete effectively to serve consumers and commerce.

In the past, depository institutions competed among themselves in a special business preserve created by the law. Neither technology, new financial instruments, nor changing customer demands posed a real threat. Dissatisfaction with service was communicated through Congress or the regulators as much as through the market.

Realities of Competition and Innovation

Those days are gone for all depository institutions. And they should be. The price for banks' security was paid for: (1) by them, since they had to operate within stringent restrictions; (2) by consumers, who had ceilings on savings rates and limited investment options; and (3) by businesses, many of which were forced to raise funds through less efficient intermediaries.

Eventually, depositories began to challenge the geographic preserves of others. High inflation blew the lid off of interest rate ceilings. New competitors from the securities world began to offer the same services as banks at better prices. Formerly illiquid credit -- commercial loans, mortgages, car loans, consumer receivables -was packaged and sold in the capital markets. Advances in communications and information management made it possible to channel capital, create liquid markets, and analyze investment relationships in ways unthought of not long ago. Funds began to travel electronically almost instantaneously around the globe. Loans became commodities and the economies of scale were transformed drastically.

Serving the consumer has become a profitable business; thus, it has attracted business. GMAC is now the largest mortgage servicer in the United States. An active secondary market in home mortgages moves billions of dollars around the nation, reducing and equalizing rates in an efficient manner, greatly assisting homebuyers by making more credit readily available. In addition, retailers have seen an opportunity to apply their marketing skills to serve customers previously ignored by traditional providers of financial services.

For example, First Nationwide Bank, a savings bank which is a subsidiary of the Ford Motor Company, announced recently its intention to expand its operation by establishing at least 150 new branches in K Mart stores around the country. First Nationwide is currently the seventh-largest savings institution in the United States; the K Mart plan would increase its total branch network by nearly 50 percent in one year. Many other retail chains, including Sears, Roebuck, J.C. Penny, and Kruger Co., have in recent years begun offering a wide variety of financial services to their customers.

Consumers welcome this competition and innovation. It accords with the needs of all working people. They prefer lower rates on their mortgages and a greater selection of mortage types to paying an extra price to a familiar but not necessarily friendly local lender. (And filling out the forms in the privacy of their home after making contact by phone and mail isn't so bad either.)

They like to have consumer banks or other companies offering special services or better terms for their credit card and transaction business -- especially if there is full disclosure of pertinent information.

If they have some money saved, they'd like to have a financial advisor to consult about the range of suitable investments. Most people need savings to send their children to college and they deserve a comfortable retirement. A little extra money saved or earned on other money will enable them to splurge now and then on leisure activities. They also want a sound deposit insurance system to guard against a calamity that can destroy all they have saved.

A recent survey published in the American Banker lends support to this view of consumer preferences. A quickly growing majority thinks it is a good idea if companies other than banks get into the banking business (56 percent in 1986, up from 44 percent the previous year). This support for new financial service competitors is strongest among people aged 18 to 34.

The open-ended questions that probe peoples' feelings reveal a notable percentage (30 percent) favoring change because it creates more competition, more opportunities, or more selection for consumers. When asked to choose which institutions are in the forefront of change and innovation, the public is twice as likely to select a diversified financial company instead of a traditional depository institution. People who already have some access to the new competitors, for example, through a Discover Card, seem to be pleased with the service: they are even more likely to consider the diversified providers as innovators, and they tend to favor more strongly the idea of nonbanks in the banking business.

While people with more income generally favor more competition in the financial services industry, surveys reveal receptivity among low-income Americans, too. A four-year old Cambridge Report survey showed that 10 percent of the public -- mostly with lower incomes -- would "bank" at Sears or J.C. Penney.

New Products and Services

The 1980s have witnessed tremendous growth in the financial services industry and new product and service development. Innovative services like CMA accounts and securitized assets are being offered by diversified firms like Sears, Merrill Lynch, and American Express. Given the demands of increasingly sophisticated consumers, technological breakthroughs, and competitive market pressures, there is every reason to believe this trend will continue.

Diversification has been a boon to these new entrants and their customers, but a challenge to the traditional banking industry which remains limited to banking. As products like securitized loans, commercial paper, and mortgaged-backed securities have replaced traditional loans as sources of funds, the banking industry's traditional customer base has eroded.

Mortgage-backed securities alone have grown to a projected total volume of $600 billion by the end of 1986 -- more than all the outstanding loans to the nation's businesses from commercial banks. In 1985 car loans, commercial mortgages, credit card receivables, and lease receivables, were securitized for the first time. General Motors, for example, is packaging car loans -- once the bread and butter of particularly small commercial bankers -- as securities and selling them in Europe and Japan.

Because banks are prohibited from offering these new securities products, many -- including Morgan, Bankers Trust, and Chase -- have been giving serious thought to relinquishing their charters in order to survive in the new environment and serve their customers by modern means. Meanwhile, the securities, mutual funds, and insurance industries are reaping the benefits of their competitive advantage and doing all they can to preserve it.

The Treasury Department supports expanded product and services opportunities for banks through separately capitalized affiliates. The minimum of these new opportunities should include underwriting and engaging in the sale of commercial paper, mortgage-backed securities, mutual funds, and municipal revenue bonds. We also would encourage this Committee to authorize the Federal Reserve Board to allow bank holding companies to engage in "activities of a financial nature" to keep pace with the modern financial world.

Consumer Banks

The Norman Rockwell picture of financial services that some individuals would like to paint is a thing of the past: families all across America are seeking, and will continue to pursue, a financial system that serves their economic needs and meets their requirements for safety, convenience, and diversification. These demands for service, competition, and the best price and product ring loud and clear.

The **Chairman**. Thank you very much, Secretary Gould, for a very good statement.

As I understand it, the key differences between the FSLIC recapitalization plans of the U.S. League and the Treasury is the borrowing arrangement. Please explain the differences in the borrowing arrangements in both your own and the U.S. League plan as you understand it.

DIFFERENCES BETWEEN THE TWO PLANS

Mr. **Gould**. Well, yes, sir, not only the arrangement is different but very clearly the amount of borrowing available under the plans are different.

The U.S. League has called for borrowing $5 billion over 2 years. Our plan allows borrowing, if it is necessary, up to $15 billion. And when we were asked by Congress to come forward, we were asked to come forward and solve FSLIC's problem. When we then spent time researching the extent of FSLIC's problem, we identified it through the work of others, the Fed Bank Board and other experts, as approximately $25 billion. So our definition of "solution" was a plan which raised enough money to handle the identified problems over the period that it would take FSLIC to actually mechanically and administratively resolve those problems. So we came up with $15 billion in borrowing which with $10 billion from assessments and investment income would produce the $25 billion.

The U.S. League plan, in our view, ignores the fact that the problem is out there and is out there to that degree. They borrow $5 billion and with the other assessments produce another $5 billion over 2 years and at the end of 2 years no one knows what happens.

If the problem is bigger than that, then they are going to have to come back and reformulate an entirely new financing mechanism. Indeed, in the process of just coming up with an inadequate amount of money they have actually burdened the Federal Home Loan Bank Board in a far greater way than our plan, so that I would question whether there is then even the inherent flexibility to go forward and raise the additional amounts of money necessary.

Now our plan does not require that FSLIC go out and burden themselves with the entire $15 billion of borrowing at the front end. If as they get into resolving cases they find the problem is less, then they don't have to borrow the rest of it. So the amazing thing to me is that our plan raises the same $5 billion the U.S. League talks about in a far more efficient, less costly way. If the issue is how much money do you want to raise, if you only want to raise $10 billion which we think is inadequate to spend over that time, ours is a much more efficient way of doing it.

To try again to respond very specifically to the thrust of your question, Mr. Chairman, in our plan we take $3 billion as needed from the Home Loan Bank system's surplus capital—surplus defined as their earned surplus as opposed to the stock owned by the industry. We take that over time as it's available. We go out and we buy zero coupon government bonds to guarantee the repayment of the principal which a financing entity then raises in the public market, that is then advanced as an investment to FSLIC and is passed through and used to resolve cases.

The principal is guaranteed by the zero coupon bond so that no one worries about getting their money back.

The **Chairman**. Let me just refine this just a little bit. What are the maturity, the interest rate, and the other key assumptions used in the U.S. League plan and what is your assessment of their plausibility?

Mr. **Gould**. All right, sir. In their plan—and I know this gets a little bit complex—but they sell zero coupons and they sell 20-year zero coupons at an assumed rate of interest of 8 percent. I would suggest to you from the background of a lot of years in Wall Street that that is a very unrealistic assumption; and I understand there will be testimony at least in the House by experts who will, I believe, come to the same conclusion.

First of all, the market out there simply isn't there for zeros. If you look at all the corporate zeros that have been sold in the last few years, they have been less than $1 billion a year and over 10-year maturity they have been about $500 million for 3 years.

So first of all, they have a mechanic—a design of a security for which there is limited discernible present market.

Then they say, "Well, we're going to sell those at 8 percent." Well, I suggest that our long-term governments are selling at 7.5 percent and to sell them only a half a point greater interest than government is to me quite naive, particularly when one looks then to see how those things get repaid. Remember, if you buy a zero coupon, you don't get one dime until they come due. It just accumulates on its face but no money passes hands until maturity.

So you're taking the risk 20 years in the future of getting your money. The interest and principal is repaid by taking the 20 percent statutory retained earnings of Home Loan Banks and devoting them to the interest and principal ultimately through a sinking fund for these securities. It's very hazy because, well, if that's not enough, then maybe somehow we will assess the industry down the road. I think you can't sell 20-year paper anywhere near 8 percent when you've got no return at all until the end of that period and a doubtful stream of servicing income. And at 8 percent it's more expensive than our plan. In fact, they actually raise, for half the cost, a third of the money we do and at a cost of $22 billion over time to the Home Loan Bank system. If you just go from 8 percent, which they project, to 10, that cost goes to $35 billion of future payments.

I don't believe it's feasible and I don't believe they will very easily raise the money for that paper and, again, it totally begs the issue of whether that is an adequate amount of money to handle the problems that exist now of this industry.

The **Chairman**. Thank you, Secretary Gould.

Senator Gramm.

Senator **Gramm**. Thank you, Mr. Chairman.

As I look at this debate, one of the things the U.S. League is arguing is that there are going to be incentives for institutions to move out of FSLIC into FDIC under your plan. I guess as I look at their plan, I come to the same conclusion, that there will be some incentives under either plan.

POSSIBLE MOVES OF S&L INTO FDIC

No. 1, how significant do you think those incentives are in view of the regulations the States impose that have differential powers for savings banks as compared to savings and loans—how much of that do you think will occur?

Mr. GOULD. Well, I think the answer is somewhat complex, Senator, because I think there are different motivations within different tiers of the industry. We have asked the FHLBB as to how much of the industry they think qualified under the rules of the FDIC to move from the FSLIC to the FDIC. Indeed, we have had discussions with Chairman Seidman in the same respect. I think it is a little hard to determine. One operative number might be on the order of 15 percent of the assets of the industry fit the rules for movement, but I don't want to emphasize that too much because I am not totally—I don't have as much information on it yet as I would like to.

Senator GRAMM. One-five, right?

Mr. GOULD. Yes, 15 percent of the total assets. Again, I don't lean on that too hard but just as an order of magnitude to qualify because FDIC's standards are quite high, particularly when you're dealing with an industry that largely has far less capital than the commercial banking industry.

The second point, sir, is, to move to the FDIC and become a bank, one has to give up a franchise as an S&L that in many cases has caused prosperity for these institutions, and how willing they are to suddenly change their spots and go down a rather different road I don't know. There certainly have been threats of large groups wanting to leave. I have never been totally convinced whether that is because they really want to leave or they are trying to negotiate not having to pay the costs themselves.

Are there some clearly major institutions that could leave? Yes, there are, sir. Thus, we have said to the Bank Board that we support in concept the idea of an exit fee.

One of the things you really might keep in mind here is that one of the reasons that FSLIC is in trouble is that the insurance premiums on this industry were too low in the past. The degree of risk inherent in the S&L industry retrospectively has turned out to have been greater than the insurance fees charged.

So an exit fee to us has at least the equity in concept of saying you didn't pay enough in the past. Before you leave us and go on to what you perceive as greener pastures, why don't you pay up your past dues? As to the exact amount of that we are not prepared to give a definitive number, but I know the Bank Board is working on that.

Senator GRAMM. Now is that part of your recapitalization plan?

Mr. GOULD. No, sir, it is not. Our plan is exactly the plan that was introduced last year and passed by both Houses.

Senator GRAMM. Now if there were an exit fee, would that have to be adopted by the Congress or could the Federal Home Loan Bank Board impose that?

Mr. GOULD. Well, sir, I feel that Chairman Gray could answer that in more specificity than I. It may be that depending upon the

The last thing we want at this juncture is to go back in time and protect oligopolies -- either product, or geographic, or managerial -- which only lead to higher costs to customers, less efficiency and lower economic growth. Closing the so-called nonbank bank loophole would do just that.

First, some people say that the nonbank bank loophole is a threat to safety and soundness because there is no way to effectively separate the fortunes of the bank from the fortunes of its parent, or because there is no way to avoid abuse of the payment system by an unsupervised parent. As we have described at length in previous testimony, however, the holding company structure and appropriate regulations can effectively insulate the depository from any risks undertaken by its nonbank parent and affiliates.

Contrary to popular belief, consumer banks themselves are supervised and examined by the federal regulators in the same fashion as full service banks. We know of no consumer bank which poses a threat to either the federal deposit insurance system or to the Federal Reserve's control over the nation's payments system. As a recent Federal Reserve Bank of Chicago study concluded: "Fears that nonbank providers of financial services threaten the viability of the banking industry and the viability of other traditional suppliers of financial services are unwarranted."

A second, well worn assertion is that consumer banks erode the separation of banking and commerce, which can lead to unfair credit allocation. Yet any credit allocation problems can be resolved by specific regulations, for example, limiting affiliates to arms length transactions fully collateralized, and providing severe sanctions against tie-ins and conflicts of interest. It also seems unnecessary to prohibit consumer banks altogether when their benefits can be substantial and any identifiable problems can be managed adequately by regulation. Furthermore, the same argument would apply to unitary savings and loan holding companies, yet they have been around for years without any significant problems. (Sears has owned a depository institution since 1958 -- almost thirty years -- without causing any concern to either FSLIC or the payments system.)

Third, some believe that consumer banks magnify competitive inequities in our financial system by allowing any company into the business of banking while banks and their holding companies are restricted to traditional lines of banking. The competitive problem can best be handled in our judgment by allowing more freedom to banks, not by pulling back on the pro-competitive aspects of consumer banks.

It is time that the debate on consumer banks moves beyond the rhetoric and begins to take a hard look at the facts. Consumer banks have been around for years in various forms. None has gotten into serious financial trouble, let alone precipitated a financial collapse as some may predict. Obviously, these institutions are meeting individuals' financial requirements and they serve their customers well. If they didn't, they wouldn't exist for long.

With the myriad of problems that face Congress, we question how the public interest is served by shutting down what are, in the final analysis, healthy, regulated, special purpose banks which are meeting the investment and credit needs of consumers all across the country.

South Dakota Loophole

You have asked for Treasury's comments on the so-called South Dakota loophole. Simply put, the South Dakota law permits state bank subsidiaries of out-of-state bank holding companies to engage in virtually any activity, so long as that activity is done outside of the state's borders. It strikes us as a bit odd, and beyond the sense of fair play, for any state to permit federally insured institutions to engage in activities beyond its geographic borders which it denies to its own state banks within that state. Accordingly we would support efforts to ensure out-of-state institutions the same powers as state institutions within any given state.

Consumer Safeguards

Mr. Chairman, I would like to stress the Administration's support for consumer safeguards in a modern financial world. We believe depository institutions should be required to disclose their check-hold policies and we believe the FRB should, as quickly as possible, issue rules designed to speed up the now cumbersome and time-consuming process of clearing checks. All consumers ought to have access to their own funds as soon as humanly and technologically possible. A model, which by all accounts works quite well, exists in New York State and could be the focus for your review.

The Administration has consistently supported requiring financial institutions to disclose fully their fees, interest rates and other factors that affect consumers. The more information individuals have, the better they are able to select institutions which are willing to serve them in the most beneficial and efficient manner.

International Competitiveness or Protectionism?

International competition and the globalization of financial markets underscore the need to reevaluate restrictions on U.S. financial institutions. In a recent speech to the Council on Foreign Relations, Secretary Baker described America's choices to reconstitute its leadership in world economic affairs. They are, he said, either to prepare ourselves to compete in an unknown land or to turn away toward a road well worn from travel by protectionists and isolationists seeking the easy and simple course -- a road that ultimately leads nowhere. If we are to compete effectively in global financial markets, we must remain out front.

Yet the opposite seems to be occurring in a segment of our financial industry. Outdated and unfair restrictions on the U.S. banking industry are hindering its ability to compete in global markets. Instead of making our banking system stronger, as these laws intended, they are making it weaker. While only one U.S. bank is among the 10 largest in the world, Japan now has the largest, four of the five largest, and seven of the 10 largest (the other two are French).

Meanwhile, the United Kingdom recently deregulated its financial markets with the much publicized Big Bang, and Canada -- our largest trading partner -- is taking steps to modernize its financial sector framework to keep pace with the rapidly evolving global environment.

There is much debate in the halls of Congress these days about the competitiveness of various sectors of the U. S. economy. If we care about keeping the United States and its financial institutions competitive, then protectionist solutions to perpetuate financial oligopolies and deny opportunities for new players in the marketplace clearly are not the solutions we should seek.

America cannot have a fully competitive trade position with a less than fully competitive financial sector. We too must modernize our system if we are to regain our leadership in world financial markets.

Conclusion

Instead of turning back the clock toward needless reregulation, we believe government should promote a freer, more competitive financial services marketplace, complete with appropriate protections, proper supervision, and meaningful disclosure. There are many who share our vision of a more modern financial world. As more and more people in this country benefit from these new entrants, the pressures to reform our nation's outmoded statutes only can increase.

New ideas are pouring out -- about more expansive financial services holding companies, for example. Many people are recognizing that it makes sense to permit anyone to own a bank -- as long as the insured deposits, the payments system, and the connections to owners are prudently regulated in a common fashion. Earlier this month, six leading bank trade organizations announced a joint exploration of some of these topics. The so-called Mayflower Group, a diverse, cross-section of banking, securities, insurance, and retail organizations, is working in the same general direction and has just issued a statement of forward looking principles -- that we heartily endorse -- by which to measure any new financial world Congress might create.

I respectfully suggest that the Congress and the Administration seize upon a unique opportunity in history to make a real difference from which the people of this country genuinely can benefit. Disparate groups are pulling together to support basic principles of fundamental reform of our financial system. We should build upon these creative efforts to ensure real, competitive reform. It is time for a change. America needs to reposition itself on the leading edge of the financial services world.

In our judgment, it would be a grave mistake to enact legislation which contains a heavy dose of reregulation, perhaps with a few product opportunities for bank holding companies, and then assert that all is well. If we care about having financial institutions that can prosper amid tough, international competition, if we want the best possible service for consumers and industry, and if we believe in a legal structure that recognizes how the world has changed, then we cannot fool ourselves with protectionist legislation that attempts to rebuild old and crumbling walls among providers of financial services to the public.

In closing, Mr. Chairman, I strongly encourage you and your colleagues to give the highest priority to the FSLIC recapitalization proposal and the regulators' proposals, as the first stage of your actions. Then, after we have addressed these urgent safety and soundness concerns, we should work jointly toward a fundamental restructuring of our financial services industry so we can meet the challenges of the changing marketplace successfully and safely.

We look forward to working closely with you and will assist you in any way that we can.

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Description of the Treasury/FHLBB Plan to Recapitalize the FSLIC

The Treasury and the Federal Home Loan Bank Board (FHLBB) developed this plan in alliance with the leadership of the twelve Federal Home Loan Banks (FHLBanks), whose contribution of up to $3 billion of capital is at the core of this effort to strengthen FSLIC. We also have worked closely with the leaders of the thrift industry. The result, is a proposal that will strengthen FSLIC, free FSLIC to resolve its problem cases more expeditiously, and increase depositor confidence.

Need for This Proposal

Estimates of the size of the problem confronting FSLIC vary widely. Most range from about $15 to $30 billion. The crux of the problem is that the assistance costs, even under the most conservative estimates, exceed FSLIC's present financial reserves.

If we do not recapitalize the fund, FSLIC would need to continue deferring the resolution of many problem S&Ls. This deferral would only increase the fund's ultimate costs. With the appropriate financial and organizational resources, the FHLBB and FSLIC could set more ambitious targets and resolve more cases, more quickly.

This is a propitious time to act. The attractive interest rate environment provides the ideal window of opportunity to move ahead vigorously to deal with ailing S&Ls.

Action now on the thrift industry problem should reaffirm depositor confidence in the health and stability of depository institutions and the viability of the deposit insurance funds. Furthermore, prompt handling of the most debilitated S&Ls should help healthy S&Ls by lowering their cost of deposits, which have been bid up by the feeble S&Ls' call for funds at any price.

If we do not strengthen FSLIC now, we may place the S&L industry at considerable risk in the future should interest rates rise significantly.

Objectives Guiding the Recapitalization Proposal

Six major objectives guide our FSLIC recapitalization proposal.

First, the proposal balances the financing burden between the Federal Home Loan Banks (FHLBanks) and the S&Ls. The cost will be borne entirely by them, without any taxpayer funds.

Second, funds are transferred from these sources to FSLIC through a combination of assessments and stock purchases (most of which will be non-redeemable under all circumstances) to avoid a negative budgetary effect.

Third, this plan can supply up to $25-30 billion to FSLIC over the next 5 to 6 years, with approximately $15 billion available in the first 3 years. Given FSLIC's organizational constraints, this infusion probably represents the maximum level of resources that FSLIC can efficiently use to resolve problem cases. Because the plan is flexible by design, FSLIC need not draw this full amount if the size of the problem turns out to be at the low end of the estimated range.

Fourth, the funds transfer to FSLIC is not dependent on any U.S. Government or FSLIC guarantees of debt.

Fifth, the proposal seeks to accommodate the FHLBanks' concerns about a substantial increase in their debt costs and the accounting treatment of their capital contribution. It also recognizes that the allocation of contributions among the FHLBanks needs to take into account their proportions of FDIC-insured members.

Sixth, this plan addresses the S&L industry's overwhelming concern -- the continuation of the FSLIC special assessment -- by creating the substantial likelihood that this extra assessment can be phased out over the next five years. (The special assessment is one eighth of one percent of deposits, in addition to the regular assessment of one twelfth of one percent.) We believe it is important to show the high probability of eliminating this extra premium over time (even if the problem cost turns out to be $25 to $30 billion), because it is a heavy burden on the industry and this will tend to decrease the incentive for healthy thrifts to switch from FSLIC to FDIC insurance.

Description of the Proposal

In essence the recapitalization proposal leverages both the current earned surplus of the FHLBanks and future FSLIC assessments to get equity funds into FSLIC more quickly. A separate corporation (the "Financing Corporation") capitalized by the FHLBanks will undertake a specially designed financing over time to channel equity investments into FSLIC. The proposal contains important safeguards to ensure that both the principal and interest on the Financing Corporation's special borrowings will be repaid.

Most of the Financing Corporation's investment in FSLIC, however, will be in the form of non-redeemable capital certificates that will never be repaid. The remainder of the Financing Corporation's investment in FSLIC will be in the form of non-voting capital stock that may or may not be repaid, with or without a return, depending on FSLIC's financial performance (as measured through FSLIC's reserve-to-deposits ratio).

The key elements of the proposal are as follows:

- o The FHLBB charters a "Financing Corporation," capitalized with no more than $3 billion of the FHLBanks' surplus over about 5 to 6 years. (The FHLBanks had $1.8 billion in earned surplus at year-end 1985 and this is expected to increase to over $2.3 billion at year-end 1986.) The Financing Corporation will not have its own paid staff.

- o The Financing Corporation borrows approximately $15 billion through long-term bonds (15 to 30-year maturities) over these five to six years. It assures payment of these bonds' principal by using no more than $2.2 billion of the $3 billion to purchase long-term, zero-coupon instruments, which will equal the bond principal upon maturity and will be held in a separate segregated account. The remaining $800 million or more of the FHL Bank investment will be used to pay fees and interest costs. The Corporation will be subject to stringent limits on activities, leverage and life. (The FHLBanks estimate that the Corporation's debt will yield 50-75 basis points, a half to three quarters of a percentage point, above Treasuries of comparable maturity.)

- o The Financing Corporation then invests the same amount the FHLBanks invested in it (a maximum of $3 billion) in non-voting capital stock of FSLIC and an additional $10 billion (or more) in non-redeemable capital certificates of FSLIC.

- o The Financing Corporation would be given limited assessment authority over the FSLIC insured institutions. The Financing Corporation would use the income raised through the assessments only for paying the interest on and issuance costs of the $15 billion of long-term bonds and for custodian fees for its segregated account holding zero coupon instruments.

- o The Financing Corporation's assessment authority would be further restricted to 1/12 of one percent of deposits, with exceptional authority to charge an additional 1/8 of one percent if the FHLBB gave its approval.

- o The FSLIC's authority to assess premiums would be reduced by the amount of all Financing Corporation assessments for that year.

- o FSLIC uses the assessment income not used by the Financing Corporation to add to its case resolution resources. The combination of equity, assessments, and earning on investments enables FSLIC to deploy about $15 billion in case resolution funds in the first 3 years and about $10 billion more over the next 2 years.

- o The special assessment can be phased out gradually over 5 years, while still securing this $25 billion for FSLIC.

- o The Financing Corporation would repay its debt principal (through the maturing zeros) around 2020. FSLIC would not be responsible for repaying this debt, nor would it be contingently liable for it.

- o FSLIC would retire its outstanding stock, held by the Financing Corporation, after the Corporation repays all its debt. (The book value of the FSLIC stock could be as high as $3 billion, if the FHLBanks make their full capital contribution to the Corporation.) The payoff of both the book value and a return on this stock upon retirement would be totally dependent on FSLIC's financial performance (its reserve-to-deposits ratio). After 1996, if FSLIC's reserve-to-deposits ratio reaches certain levels, FSLIC would make contributions to an equity return account. This account, which would be held by FSLIC until the Financing Corporation paid off all its debt, would be the sole source of funds for paying off the FSLIC stock. The non-redeemable capital certificates issued by FSLIC would be extinguished without any repayment.

- o The Financing Corporation must sunset by 2026 (or earlier if it has repaid all its debt); its ability to borrow net new funds would end in 1996.

- o The attached diagrams illustrate how the proposal would operate.

Flexibility of the Proposal

This proposal incorporates some flexibility in the event the industry problem is larger than estimated and FSLIC needs more funds. Alternatively, the structure could employ less funds from the FHLBanks and the industry if the problem proves less costly.

First, in the event interest rates rise, the face value of the zero-coupon instruments (the value at maturity) that can be purchased by the Financing Corporation will increase. More face value can be acquired because a zero-coupon instrument in effect pays off all interest, at a compounded rate, together with the amount originally invested, when the instrument matures; so a higher interest rate compounded over time will produce a higher face value amount of a zero-coupon instrument for a given initial investment. This increased amount at maturity would enable the Financing Corporation to use its initial capital to back a larger amount of borrowings.

Second, the Financing Corporation could generate a larger payoff from the zero-coupon instruments it purchases by selecting ones with longer maturities (more years to compound the interest).

Third, if FSLIC needs more money earlier, the FHL Banks could invest a greater percentage of their $3 billion in surplus in the first several years. Currently, we have the FHL Banks' investment spread out over a seven year period.

Fourth, currently, the plan calls for $800 million of the FHL Banks' $3 billion investment in the Financing Corporation to be set aside in a reserve to pay for interest and other expenses. This amount could be used to purchase additional zero coupon bonds to pay the principal of increased borrowing, if necessary.

Fifth, if absolutely necessary, FSLIC could maintain a portion of the special assessment. While FSLIC should preserve this additional assessment authority, its use beyond the 5-year phaseout should be avoided if at all possible.

Budgetary Treatment

This proposal is structured carefully to create fair and appropriate budgetary receipts that will offset FSLIC's case resolution costs (which are scored as budgetary outlays).

Last year the Congressional Budget Office (CBO), with the concurrence of the General Accounting Office (GAO), ruled that it would score as offsetting collections the full amount of funds provided to the FSLIC by the financing corporation. The recapitalization of the FSLIC will not be counted as federal borrowing by CBO.

Benefits

To summarize the benefits of this FSLIC recapitalization proposal

- FSLIC will be able to employ about $25 billion over 5 years to resolve its case load of problem thrifts. These funds should be transferred to FSLIC about as quickly as we can reasonably expect the FSLIC organization to handle its problem cases effectively.

- By handling insolvent S&Ls more expeditiously, FSLIC can halt the expansion of the problem.
- The certain availability of about $25 billion for FSLIC should increase depositor confidence. This confidence, plus the sale, merger, or liquidation of the weakest S&Ls, should help the industry lower its cost of funds.
- The FSLIC recapitalization burden will be shared fairly between the S&Ls and the FHLBanks. Moreover, the contributions are structured to minimize the adverse effects on both. There is a high probability that the special assessment on the S&L industry can be phased out over 5 years.
- Regular FHLBank debt should be protected from possibly higher borrower spreads.
- The legislation requiring the FHLBanks' investment in the Financing Corporation would resolve the FHLBanks' concerns about fulfilling fiduciary duties.
- The equity nature of the FHLBanks' capital contribution to the Financing Corporation -- which links the repayment of the stock and the possibilities of higher returns to FSLIC's financial performance -- should ease the FHLBanks' accounting treatment. Moreover, it gives the FHLBanks (whose Presidents are the FHLBB's principal supervisory agents for each district) an additional future economic interest in the condition of FSLIC and the industry.
- The formula that governs the FHLBanks' capital contribution will accommodate FHLBanks with a large percentage of FDIC-insured members.
- Finally, the flexibility built into the proposal permits the FHLBB to raise a range of funds for FSLIC, depending on FSLIC's needs.

degree of an exit fee that it would require legislation, but I think he better can say what's on his statutory books than I.

Senator **Gramm**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Gramm.

Senator Riegle.

Senator **Riegle**. Mr. Chairman, I have really two questions I want to get into.

When you look at the President's budget that we just received in the Budget Committee a short time ago, they are forecasting that the failures of banks and thrift institutions for this year and next will cost the Government almost $10 billion more than they previously had predicted.

LIQUIDITY OF THE FSLIC AND FDIC

Now FSLIC is down to about $2 billion in usable assets and, as I understand it, the deficit that's likely to accrue this year will exhaust that in all likelihood and perhaps by quite a margin.

Now there's more strength over at the FDIC where there's about $18 billion there, but the estimate is for the cash deficit on handling bank failures for this year of something over $4 billion. So that would draw down that remaining surplus that's there.

Last year there was a projected surplus of just about $2 billion, so you see from going from a $2 billion surplus to a $4 billion deficit there's a $6 billion swing there year to year.

How healthy are our two deposit insurance agencies? I find this very sharp upward adjustment in projected losses on both sides to be unsettling. So how would you assess the two deposit insurance agencies?

Mr. **Gould**. The insurance funds themselves, Senator?

Senator **Riegle**. Yes.

Mr. **Gould**. I think FSLIC is in an extremely weak position. FSLIC has moved to a worse position from last year, when we were arguing that FSLIC needed more money to deal with insolvent institutions that were losing money, for a couple of reasons.

One, the longer you waited, the greater the tab was at the end of the road. Second, insolvent institutions gathering money against federally insured deposits were raising cost of money to the industry as a whole and, indeed, even for the commercial banking system.

So there was an urgency to get at an existing, recognized problem. FSLIC this year, however, is merging on an even greater risk which is a liquidity risk in the industry where the deterioration in FSLIC's reserves make them unable to guarantee Federal Home Loan Bank system loans to troubled institutions.

When you start talking about not just resolving problem cases but start talking about liquidity problems, you are in my view moving into much more dangerous territory. So FSLIC is in poor shape and shifting into even worse shape.

The only reason FSLIC has any money at all is that no one has made additional recapitalization available to them and they just haven't resolved cases they should have because they didn't have the money. We can't say that they still have $2 billion and that means the problem isn't out there. The problem is they don't have any money and they don't want to spend their last dime when they're backing up $900 billion of deposits.

So FSLIC I would say, by anyone's standard, is in poor shape.

The FDIC, on the other hand, I consider to be a very fortunate occurrence for all of us, and for the country, in having on the order of $18 or $19 billion of accumulated money. Although we have been resolving a record number of bank failures, albeit in general rather small banks, we are hardly scratching the principal of that fund which remains almost entirely available for future problems and that's a lot of money to handle future problems.

Now one thing I'm sure is obvious to you, Senator, but just to make a point, when you have $18 or $19 billion in assets you also have an awful lot of investment income. If you're in 2-year Treasury notes, you're probably getting $1 billion dollars a year. So you have the assessments plus the $1 billion from investments and that's what largely has been used so far.

MERGER PROPOSITION

Senator RIEGLE. Let me ask you this. I've always opposed merging the FSLIC and the FDIC, but more and more people are suggesting that openly.

What would be your view on whether or not that's a sensible proposition if you think seriously about putting the two together?

Mr. GOULD. I'm happy you asked me the question. The trouble with merging the fund is like a lot of things I'm afraid. We kind of get into phraseology about conceptionally merging the funds, and I'm afraid a lot of people's minds jump from that phrase to the fact that FSLIC means money so we just dip into this other pot over here. We give FSLIC the money and then FSLIC doesn't have to go out and get any more money to handle their problems on their own.

That is not our concept of merging and that has not been Chairman Volcker's concept when I've discussed it with him, nor indeed has that been the concept of what merging the funds means to Chairman Seidman. We are talking about merging two industries regulatorily, but we are talking basically about maintaining two separate pots of money with disparate assessments on the industry to represent the higher risks in the S&L's as opposed to the lower risks in the commercial banks.

So merging the funds means you merge them under a single regulator but it does not mean that you don't need to go out and get additional funds for FSLIC and it does not mean that S&L's would come in under the same one-twelfth assessment every year as the banks have.

It is organizational merger far, far more than a money merger.

Senator RIEGLE. My time is up. I would like to pursue it, but I can't.

The CHAIRMAN. Thank you very much, Senator Riegle.

And thank you, Mr. Secretary. We would like to question you further. Unfortunately, we can't do it with our time constraints. I know you have a deadline. So thank you very much, sir.

Mr. GOULD. Thank you, Mr. Chairman. I didn't expect to get off on nonbank banks that lightly.

Senator RIEGLE. You won't in the submitted questions.

The CHAIRMAN. We have the Chairman of the Board of Directors of the FDIC, Mr. Seidman; the Chairman of the Federal Home Loan Bank Board, Mr. Gray; and the Comptroller of the Currency, Mr. Clarke, as our next witnesses.

Gentlemen, as I announced earlier today, we are going to proceed on a new basis with a maximum of 10 minutes. If you can do it in less, we would be delighted and probably give you more credence. The hour is late. I know you have other appointments. So go right ahead. We'll do this alphabetically by the name of the regulator. Mr. Clarke, we'll start with you.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Thank you, Mr. Chairman. I will try to keep it under 10 minutes.

Mr. Chairman and members of the committee, I am pleased to have the opportunity today to appear before you to discuss a number of the important issues that were considered by the committee in the prior Congress. My views on the five topics that you outlined in your invitation letter are set forth in detail in my written statement, which I request be made part of the record, and in the interest of time I will only summarize the statement.

The CHAIRMAN. Without objection, that will be done.

Mr. CLARKE. Of the five topics mentioned in your letter of invitation, I believe that two should be addressed immediately.

RECAPITALIZATION OF FSLIC IS ESSENTIAL

First, the recapitalization of the Federal Savings and Loan Insurance Corporation is essential. The Federal supervisors of the thrift industry must have the resources needed to resolve the problems of the large number of insolvent institutions. I am particularly concerned about the continued operation of insolvent thrifts for two reasons. First, it has increased the funding costs for healthy institutions, both thrifts and commercial banks, that have to compete with them. And, second, it threatens to erode public confidence in the deposit insurance funds and the stability of our financial system.

The second topic of immediate concern is the need for the emergency acquisition provisions of the 1982 Garn-St Germain Act which expired last October. Those provisions must be reinstated and strengthened. It has been suggested that emergency authority is no longer necessary because a number of States have enacted interstate banking laws. I do not agree. Some States with high concentrations of troubled banks still have no provisions for permitting an out-of-State acquisition of a failing bank. Moreover, in some States that have enacted interstate banking legislation, several impediments remain that make it difficult for the FDIC to arrange interstate acquisitions.

Consequently, I urge Congress to enact emergency acquisition legislation that includes the following features. It should, No. 1, authorize out-of-State banks to acquire weakened banks before they fail, thus preserving the value of such banks as ongoing institutions.

No. 2, it should make banks, regardless of their size, eligible for emergency acquisition. This would enhance the FDIC's ability to find merger partners or arrange acquisitions for the vast majority of troubled banks that are small in size. It should be noted that 97 percent of the problem national banks have less than $500 million in assets and 86 percent have less than $100 million in assets. And I think it's also important to point out that of the 41 bank failures in 1986 that resulted either in liquidations or insured deposit transfers, which means that uninsured depositors lost money, 38 were in States which did not permit interstate acquisitions. Only two were larger than $100 million in asset size.

No. 3, it should apply emergency acquisition provisions to holding companies that have material banking subsidiaries in danger of closing. This would facilitate acquisitions in States that prohibit branching but allow multibank holding companies.

No. 4, it should authorize out-of-State holding companies that acquire a troubled institution to acquire additional banks in the State in which the troubled bank is located on the same basis as an in-State bank holding company. This would make the purchase of a weak bank more attractive.

No. 5, it should amend the Bank Holding Company Act to provide for out-of-State acquisitions of failing banks in instances where no FDIC assistance is involved. This would encourage weakened institutions to find private solutions to their problems.

The authority we are advocating is intended solely as a means of facilitating the resolution of failures and near-failures in the banking industry, not as a means of effecting major changes in the respective roles of State and Federal regulators. Nor is it intended to circumvent the geographic restrictions of the Douglas amendment. If that were our purpose, we would instead urge the Congress to mandate interstate banking.

The OCC also supports legislation that would give the FDIC the authority to establish bridge banks. However, the bridge bank proposal should not be viewed as a substitute for emergency acquisition legislation. The bridge bank proposal applies only to failed banks. The emergency acquisition legislation would permit the acquisition of failing banks.

After Congress has addressed the FSLIC recapitalization and emergency acquisition authority, I urge you to consider other banking reforms.

PLACE FOR NONBANK BANKS

With respect to nonbank banks, they are, except for the purposes of the Bank Holding Company Act, in every respect banking institutions. National nonbank banks receive the same national bank charters as full service banks, are subject to the same laws and regulations as other national banks, and are subject to the full scope of our regulatory, supervisory and enforcement authority. It's really more appropriate to refer to them as limited service banks.

With respect to the question of whether those banks should be banned, I have noted on other occasions that nonbank banks represent a rational market response to the restrictions—both geographic and product and service restrictions--that have been placed on the banking industry. I would prefer to see all banks granted greater freedom to pursue diversification more directly. This additional freedom would reduce the incentives to charter or own limited service banks.

Regardless of how the issue is ultimately resolved, I want to assure the committee that I stand by the commitment I made last October to allow Congress a reasonable period to address limited service banks without being pressured by the existence of newly chartered national institutions. With that in mind, I would refer the committee to my written statement, which includes a status report on the Florida litigation involving limited service banks and on the motion recently filed by our office in that case.

You have also requested my views on the so-called South Dakota loophole. This so-called loophole is a provision of law that authorizes a State-chartered bank to engage in insurance activities outside the State while prohibiting those activities inside the State. To that extent, the statute appears to me to be inequitable. However, I support the benefits of a dual banking system and believe that great care should be taken in connection with any Federal efforts to remove the inequity.

Also under consideration at these hearings is whether legislation is needed to deal with the funds availability practices of financial institutions.

The problems associated with delayed funds availability have two causes and therefore require two distinct solutions. First, depository institutions must be encouraged to provide better disclosure of their funds availability practices. This would ensure that customers have an opportunity to make informed choices among depository institutions.

Second, efforts to improve the check return process must continue. The OCC does not view a legislatively prescribed funds availability schedule as a desirable solution. If implemented before the check return process is improved, it may force institutions to protect themselves against potential losses in other ways. This could mean higher fees, screening of depositors, or other indirect means of minimizing or offsetting losses.

Let me turn finally to some of the new opportunities that I believe banks should have to broaden their business activities and diversify the risks they undertake.

Providing short-term credit to commercial enterprises is a traditional function of the commercial banking industry. Authorizing banks to provide that credit to commercial enterprises as new products are developed would benefit customers and, by increasing the sources of bank income, would contribute to the safety and soundness of the financial system.

I believe, however, we need to ensure that the focus of discussion is not on a few new activities or powers, but on the appropriate means to protect depositors and the financial system as a whole, while allowing banks the opportunity to regain their competitive strength by delivering the products that the market demands.

MORE FLEXIBILITY FOR BANKS

Instead of an endless debate about this product or that service, our attention should be directed at designing the appropriate legal and operational structure to allow banks additional business flexibility while still achieving our public policy goals. Properly regulated, I believe that there are few, if any, business activities that cannot safely be combined with banking.

As the members of this committee are well aware, there is substantial opposition to removing the barriers between commercial and investment banking. The most frequently voiced arguments against the removal of those barriers concern the need to guard against potential conflicts of interest and concentrations of economic power, to protect——

The CHAIRMAN. Could you conclude in about 30 seconds?

Mr. CLARKE. Yes, sir, I will do that—to protect customers of commercial and investment banks, and to avoid endangering the safety and soundness of the financial system.

Those concerns are largely an unfortunate legacy from the conditions under which the Glass-Steagall Act was passed and the differences between the legal framework of today and that of 1933 are vast.

The CHAIRMAN. Thank you, Comptroller Clarke, very much.

[The complete prepared statement follows:]

For Release Upon Delivery
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Statement of

ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

January 21, 1987

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to appear before you to discuss a number of the important issues that were considered by the Committee in the prior Congress. I particularly welcome this chance to present my views to new members of the Committee who may not be familiar with the positions taken by our Office in the past.

Your letter of invitation, Mr. Chairman, requested my views on five topics: the need to recapitalize the Federal Savings and Loan Insurance Corporation, expanded authority for dealing with failed and failing banks, measures to close the nonbank bank and South Dakota loopholes, authority for bank holding companies to offer new securities services, and proposals to deal with the funds availability practices of financial institutions.

I believe that two of these issues should be addressed immediately. First, recapitalization of the Federal Savings and Loan Insurance Corporation is essential. The federal supervisors of the nation's thrift industry must be put in a position to proceed with the resolution of the problems of the large number of insolvent institutions that exist today. Without that resolution I am concerned that public confidence in the thrift industry will continue to erode.

Second, reinstating and expanding the authority of the bank regulatory agencies to deal with failed and failing banks will ensure that the regulators have the tools needed to deal with the large number of problem institutions that continue to suffer from weaknesses in certain sectors of the economy.

Those important issues have been thoroughly debated, and should be dealt with immediately without encumbering legislation. Once that is done, I urge the Committee to move ahead on an equally important issue, that is, the role banks will play in the financial services market of the future.

Mr. Chairman, I am pleased by your request for testimony on, among other things, expanded bank activities. In my view, this is an important issue on which action needs to be taken promptly. Most of your witnesses, and, indeed, witnesses at most earlier Congressional hearings on this subject, have also noted the need for reform of the legal framework governing the financial services industry. I believe that we are at a time in history when we are ready to translate the public policy debate into legislation that can bring the rules governing the financial services industry into conformity with today's marketplace realities. Changes in the financial services marketplace have created a need and an urgency for the Congress to grant banks greater flexibility to diversify their delivery of services. The resolution of this need should not be delayed any longer.

FSLIC RECAPITALIZATION

Background

In the past few years, the premium income of the Federal Savings and Loan Insurance Corporation (FSLIC) has not been sufficient to cover the expenses incurred by the agency in dealing with failing thrifts. As a result, the insurance fund's reserves are inadequate to resolve all of the known problem thrift cases outstanding -- not to mention any that may arise in the future.

To help relieve the FSLIC's funding difficulties, and to enable it to arrange the orderly disposition of insolvent thrifts, the Treasury Department, working closely with the Federal Home Loan Bank Board (FHLBB) and Congressional staff, developed a plan for recapitalizing the thrift insurance fund.

The plan, with some modifications, was passed by both houses. Unfortunately, it was not enacted by the 99th Congress before it adjourned.

Need for Recapitalization

The OCC continues to view FSLIC recapitalization as a high legislative priority and urges prompt Congressional action to enact the proposal. Without it, one of the central tenets of our system of financial institution supervision -- that depository institutions are closed by their supervisors when they become insolvent -- will continue to be violated. As a result, confidence in the supervisory agencies, insured depository institutions, and the safety and soundness of the nation's financial system may be lessened.

In addition to weakening public confidence, the continued operation of a number of insolvent thrifts has created difficulties for the majority of thrifts that are healthy, as well as for other depository institutions -- especially commercial banks. Some thrifts, because of negative publicity and concerns about their solvency, must pay a premium to attract deposits. Other institutions, competing in the same markets, must offer similarly inflated rates to compete for deposits. So, healthy institutions -- both banks and thrifts -- located in the same markets as insolvent thrifts are experiencing an increase in their funding costs. While this is not a widespread problem, in some markets it is extremely troublesome. The way to correct it is to deal with the thrifts that are insolvent -- something that the FSLIC cannot afford to do until the fund is recapitalized.

The purpose of deposit insurance is to preserve the public's confidence in the safety of their funds and thus to maintain stability in our financial system. If this confidence is eroded because of an inadequately funded insurer, stability of the financial system -- including commercial banks -- could be dealt a serious blow. Clearly this result must be avoided, for the federal deposit insurance system has played a critical role in maintaining confidence in our financial system for the past 50 years.

EXPANDED AUTHORITY TO DEAL WITH FAILED AND FAILING BANKS

Two bills were introduced in the 99th Congress to provide bank supervisors with flexibility to deal more effectively with weakened and failed banks. Those bills would have amended the emergency acquisition provisions of the Garn-St Germain Depository Institutions Act of 1982 and authorized the Federal Deposit Insurance Corporation to establish bridge banks from closed banks.

Emergency Acquisition Authority

A number of banks are experiencing financial difficulty. There are over 300 national banks on our problem list (banks with a CAMEL rating of 4 or 5[1]), an increase of more than 600 percent since 1980. Nearly seventy percent of those problem banks are located in the Midwest and Southwest, where sectoral economic problems are affecting entire states. Unfortunately, the concentration of troubled banks in those states increases the difficulty of finding strong in-state institutions willing to rescue weak institutions without substantial assistance from the FDIC. Bank supervisors must have the authority to deal with failing banks in a way that minimizes the disruption in banking services provided to the community, the potential for a decline in public confidence in the banking system, and the cost to the FDIC.

The acquisition of a troubled bank by a stronger institution often lessens the adverse effects that can result from the failure of a bank. Expanding the number of potential purchasers of weak banks and removing some of the constraints they face will enhance our ability to resolve weakened bank situations in an expeditious, least-cost manner.

The emergency acquisition provisions of the 1982 Garn-St Germain Act expired last October. Those provisions, although used infrequently, were extremely helpful in resolving large bank failures. Therefore, I strongly urge the immediate consideration and passage of a bill that reinstates and strengthens them. Moreover, I would recommend the adoption of some additional provisions.

Expanding eligibility to failing banks. First, I urge Congress to expand the emergency acquisition provisions to authorize out-of-state banks to acquire weakened banks before they fail. A bank that is still operating is more likely to attract favorable bids than is a closed bank because the open bank's value as an ongoing business can be preserved. Consequently, it requires a smaller outlay of FDIC funds than is needed if the bank fails.

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[1] A CAMEL rating summarizes the examiner's assessment of a bank's strength in five areas: capital adequacy, asset quality, managment, earnings, and liquidity.

Lower size threshold for eligible institutions. Second, making banks with assets under $500 million eligible for emergency acquisitions will significantly enhance the FDIC's ability to use the emergency acquisition authority, since the vast majority of troubled banks are small in size. Ninety-seven percent of problem national banks have less than $500 million in assets; 86 percent have less than $100 million is assets. If the size threshold is not eliminated, the emergency acquisition powers will not be of use in the majority of failed and failing bank situations. Thus, in the absence of alternative solutions, such as out-of-state acquisitions, it is likely that the FDIC will be forced to perform more liquidations and deposit payoffs, with a resulting loss in banking services to local communities. We therefore recommend that the minimum threshold be eliminated.

Extension to holding companies. Third, I favor making the emergency acquisition provisions applicable to holding companies that have a subsidiary bank or banks in danger of closing, if such bank or banks hold a significant portion of the total assets of the holding company's bank subsidiaries. In the previously proposed legislation, one third or more of the total assets of the holding company's bank subsidiaries was deemed to be significant. In addition to allowing the acquisition of these failing banks, such a measure would permit an out-of-state purchaser to acquire some of the holding company's other bank subsidiaries or the entire holding company. I do not favor, however, offering FDIC assistance to nonbank subsidiaries of the holding company.

This addition to the law would facilitate emergency acquisitions in states that prohibit branching but allow multi-bank holding companies. Under the provisions of the Garn-St Germain Act of 1982, an out-of-state bank holding company that acquired a troubled institution was not permitted to acquire other banks in that state. Thus, potential purchasers were deterred because of this limitation. It did not allow them to diversify by purchasing additional, healthier banks, even if they were affiliated with the same holding company. Moreover, in cases where the troubled bank is the lead bank of the holding company, removing it from the holding company could affect the safety and soundness of the smaller banks in the holding company.

The proposed change would mitigate these problems by allowing the entire holding company to be acquired.

Additional expansion opportunities. Fourth, I support authorizing out-of-state bank holding companies that acquire a troubled institution to acquire additional banks in the state in which the troubled bank is located on the same basis as an in-state bank holding company. Such a provision would reduce, but not eliminate, some of the competitive disadvantages that out-of-state purchasers face relative to in-state holding companies. Without some opportunities for expansion, out-of-state companies would have little incentive to bid for a troubled bank in unit banking states.

Unassisted acquisitions. I support another measure that was proposed last year: amending the Douglas Amendment of the Bank Holding Company Act to provide for out-of-state acquisitions of failing banks in instances where no FDIC assistance is involved. This would encourage weakened institutions to find private solutions to their problems before those problems reach a magnitude that demands federal financial assistance -- solutions that would reduce potential demands on the FDIC's resources.

Specific Concerns. It has been suggested that with the enactment of various forms of interstate banking laws in a number of states that have experienced a large number of troubled banks, especially in states such as Oklahoma and Texas, an emergency acquisition law is no longer necessary. This is not the case.

In the first place, there are still states that have no provisions permitting an out-of-state acquisition of a failing bank. Some of these states -- Iowa and Nebraska, for example -- have a number of troubled banks. Our experience indicates that in-state purchasers are increasingly difficult to find in those states. In addition, even in states such as Oklahoma and Texas, which have enacted interstate banking legislation, several impediments remain that may make it more difficult for the FDIC to arrange interstate acquisitions than would be the case under the emergency acquisition provisions the regulators proposed in the last Congress.

First, potential obstacles are posed by some states that are participants in interstate regional compacts that make it difficult for banks and bank holding companies within those states to enter states outside those compacts. Second, the laws that permit the interstate acquisition of failing banks create, in some states, difficulties for the FDIC because the bidding processes give a preferential bidding opportunity to in-state bidders. These provisions discourage out-of-state bidders from incurring the expense of preparing a bid when it is likely that an in-state bidder will have the opportunity to know the bid of the out-of-state bidder and top it. We support legislation that would allow the regulators to arrange an acquisition of failed and failing banks without being subject to such state laws.

Our next witness is Chairman Gray. Chairman Gray, I hope you can do this in 5 minutes maybe. We'll give you 10 but 5 would be marvelous.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. GRAY. Thank you very much, Mr. Chairman.

Senator GRAMM. Tell him you will give him recapitalization if he does it in 5.

The CHAIRMAN. Well, we'll sure think hard about that. [Laughter.]

Mr. GRAY. Understand that I'm going to talk almost completely about recapitalization.

Mr. Chairman and members of the committee, I appreciate the opportunity to join with you here in this very important hearing. It's the fourth calendar year that I've come before you in similar proceedings as Chairman of the Bank Board to share my views on the condition of the savings and loan industry and to present recommendations for strengthening the national thrift system.

PARADOX OF GOOD AND BAD TIMES

The thrift system itself continues to enjoy the paradoxical distinction of enjoying the best of times and the worst of times. On the one hand, the vast majority of the thrift industry is very profitable. After-tax earnings for the roughly four-fifths of the industry which is profitable was $6.9 billion in the first three quarters of 1986. That's the latest comprehensive reporting period. This is just short of the earnings performance registered by the profitable sector for all of 1985.

In summary, the profitable segment of the industry—again the vast majority of savings institutions—is healthy and many, many institutions are robust performers.

On the other hand, the unprofitable one-fifth of the industry is very unprofitable and of the deepest concern to me. This sector of the thrift business ran up losses during the first three quarters of 1986 amounting to $5 billion. That's somewhat more than losses reported during all of 1985.

One of the main reasons we're here today is to explore the manner in which the Government should deal with the problem of this unprofitable—but more particularly the failing—sector of the savings institutions business. The FSLIC is called upon by law to stand behind the insured accounts of savers who place their funds in the Nation's more than 3,200 FSLIC-insured institutions. These savings accounts, which amount to some $890 billion, are today protected by the FSLIC deposit insurance fund which, as has been stated before, has less than $2 billion in primary reserves, which is by the way the lowest ratio of such reserves to deposits ever.

Moreover, the thrift deposit insurance fund's reserves continue to deteriorate, and absent prompt action by the Congress to help us remedy this situation, the reserves will continue to fall without the prospect of adequate replenishment to even more alarming levels in the months to come.

Needless to say, this situation does present all of us with a fundamental challenge and, I believe, obligation which must be dealt with very soon.

Simply nothing is more important to the maintenance of a sound financial system than the maintenance of public confidence in it. The thrift system, which is an integral part of the Nation's overall financial system, is no exception. None of us can afford to forget the nature and consequences of the loss of public confidence which occurred in connection with the Ohio and Maryland thrift crisis. The public did in fact lose confidence in the back-up mechanisms which had been instituted to safeguard the funds of depositors in those systems, and the repercussions of these thrift crises were felt, as you will recall, far beyond the borders of the two States involved.

We must also address the issue of public confidence in the Nation's federally insured thrift system in a decisive and expeditious manner which conveys maximum certainty to the public that the problems of the thrift deposit insurance fund are being dealt with in a way which merits their full confidence in the thrift system now and in the future.

For 1½ years now I have been saying the thrift insurance fund must be recapitalized. Even earlier, at the beginning of 1985, the Bank Board exercised its full statutory authority to raise insurance premium contributions from FSLIC-insured member institutions to the maximum permitted by law.

It became clear to me in the summer of 1985 that these insurance premium resources would not be enough to maintain the level of reserves needed for the FSLIC to truly meet its obligations.

So working with Treasury, the Bank Board developed a plan to recapitalize the insurance fund in the first several months of 1986, and this plan, as you know, was presented to this committee last March. The basic framework was in fact adopted by both the Senate and House in the waning days and hours of the 99th Congress, although there was no conference thereafter to resolve any differences.

This plan, which would provide some $32 billion to the thrift fund if needed over the next 7 years, was reintroduced in both Houses several weeks ago.

PLAN WOULDN'T COST TAXPAYERS ONE CENT

The plan which is described in the statement I sent to you yesterday would, if adopted, enable us to begin the process of restoring public confidence in the thrift system right away by sending a clear signal to all that there would be tools and requisite financial resources in place and available over time to restore the health of the thrift fund and begin to put many of our problems behind us. I want to emphasize that the Bank Board-Treasury plan will not require the infusion of taxpayer dollars. It's entirely self-funded by the thrift system.

We are estimating that the financial resources which will be needed to resolve terminally ill thrift cases, cases that we now know about, will be some $19.5 billion. We also included another $4 billion in the overall estimate of $23.5 billion to cover what we consider to be borderline cases which could well require FSLIC assistance in the next 5 to 7 years. This leaves another $9 billion which would be available, if needed, for contingencies over the next 7 years.

Again, the basic outlines of our plan, which both Houses saw fit to adopt, would in my view provide enough money to deal with severe thrift problem cases over time, which would clearly send a message to the public that improved public confidence in the thrift system is fully merited. This would have the very, very beneficial effect of improving depositor perceptions of the thrift insurance fund itself and therefore would reduce interest costs that the thrift industry is now paying for deposits, thus further enhancing opportunities for profitability.

A study that we completed last year showed that the thrift industry as a whole was paying at least $4 billion a year more than is necessary for deposits precisely because of market concerns about troubled thrifts and negative perceptions of the FSLIC strength deriving from its weakened condition.

The spillover effects of perceptions of a weak thrift insurance fund which is incapable of resolving severely troubled and terminally ill thrift cases because the fund simply doesn't begin to have the financial resources to do so, directly contributes to higher than necessary costs of operations at all thrifts, healthy or unhealthy; and even it spills over to the commercial banks.

Today the 347 most severely troubled thrift institutions in our system are losing on an operating basis roughly $6 million a day or $2.2 billion a year. This annual loss is more than the insurance fund's entire annual income and it's $350 million more a year than the FSLIC is collecting in insurance premiums.

Our recapitalization plan would enable the FSLIC to begin to get at this problem by providing the resources we need to resolve such cases early on. We will soon be implementing a variety of measures to improve our regulatory system's ability to resolve FSLIC cases as efficiently and as cost-effectively as possible, using the expertise and the organizational resources of the entire system in a fully coordinated manner.

Nothing is more important to us in the Federal Home Loan Bank Board-FSLIC system than to safeguard the moneys in the insurance fund in the FSLIC case resolution process. The Bank Board-Treasury plan has the attribute of providing over a known period of time and in the most cost-effective manner the greatest amount of certainty that the thrift insurance fund will have the financial resources, if needed, to protect and strengthen the thrift system without the use of taxpayer funds, while at the same time improving public confidence in the system.

STRAINS ON SYSTEM ENORMOUS

Now during these past few years the strains on the thrift system itself have been enormous. The system was frankly not prepared to deal with the vicissitudes of a deregulated thrift operating environment. The Bank Board has, I believe, made very considerable gains in its efforts to modernize and strengthen the regulatory oversight apparatus and process.

The progress which has been made must continue and must be further strengthened. Without the commitment and resolve necessary to ensure that safe and sound operating practices are observed and enforced throughout the thrift industry, and without the appropriate discipline necessary to assure that this does in fact occur, recapitalization of the insurance fund, no matter how much money it provides, cannot truly succeed in its intended goal—that of getting the difficult problems that we now face behind us.

The CHAIRMAN. Thank you.

Mr. GRAY. One last sentence.

The CHAIRMAN. Finish the sentence.

Mr. GRAY. I am committed, as you know, to the goal of making recapitalization work by carrying out the continued vigilance and regulatory discipline that that commitment entails on your behalf and on behalf of the American public. And I look forward to working closely with you in the weeks ahead to achieve common objectives.

[The complete prepared statement follows:]

The authority we are advocating is intended solely as a means of facilitating the resolution of failures and near-failures in the banking industry, not as a means of effecting major changes in the respective roles of state and federal regulators. Nor is it intended to circumvent the geographic restrictions of the Douglas Amendment. If that were our purpose, we would instead urge the Congress to mandate interstate banking. These emergency measures are desired by bank regulators only because we need additional tools to deal with weaknesses in the banking industry. If you give us these tools, I assure you that we will use them carefully, and only in instances where other alternatives are not available.

On the infrequent occasions when they will be used, however, I believe that they will minimize any disruption in the local community, as well as the cost to the FDIC fund involved in resolving a weakened bank's problems. I urge the Congress to reinstate and expand the Garn-St Germain emergency acquisition provisions.

Bridge Banks

In the 99th Congress, the FDIC proposed legislation that would have given the agency the authority to establish bridge banks. We support that legislation.

Under the FDIC proposal, after a bank fails, the agency could reopen the bank as a national bank under the FDIC's control. This would give the FDIC the necessary time to assess the extent of problems at the bank and would provide potential purchasers the time to make an informed judgment regarding the value of the bank. Consequently, it is more likely that a purchase could be arranged for the bank, thus saving the FDIC money while continuing to provide banking services to the community.

While we strongly support this proposal, I would like to emphasize that the bridge bank proposal should not be viewed as a substitute for emergency acquisition legislation. The bridge bank proposal only applies to failed banks. The emergency acquisition legislation would permit the acquisition of failing banks. Also, the bridge bank proposal does little to increase the number of potential acquirors. Consequently, we support both the bridge bank and emergency acquisition legislation as complementary measures that would enhance the bank supervisors' flexibility in dealing with both failing and failed banks.

NONBANK BANKS

The Committee has asked for my views on nonbank banks. Nonbank banks are banks chartered under the National Bank Act or under authority of state law but not covered by the definition of "bank" found in the Bank Holding Company Act of 1956. Except for the purposes of the Bank Holding Company Act, nonbank banks are, in every respect, banking institutions. National nonbank banks receive the same national bank charters as full-service banks, are subject to the same laws and regulations as other national banks, and are subject to the full scope of our regulatory, supervisory, and enforcement authority. Nonbank banks receive regular on-site examinations and must obtain regulatory approval for changes in their corporate structure.

I have noted on other occasions that nonbank banks represent a rational market response to the restrictions -- both geographic and product and services restrictions -- that have been placed on the banking industry. The route they provide is circuitous and certainly not the one that would be chosen were more direct avenues open, but it is one that the market will continue to use as long as the more direct avenues remain closed.

With respect to the question of whether nonbank banks should be banned, I would prefer to see all banks granted greater freedom to pursue diversification more directly. This additional freedom would reduce the incentives to charter or own nonbank banks.

Regardless of how the issue is ultimately resolved, I want to assure the Committee that I stand by the commitment I made last October to allow Congress a reasonable period to address nonbank banks and related issues without being pressured by the existence of newly chartered national institutions.

With that in mind, I would like to explain for the record the OCC's actions in filing a motion to have the District Court for the Middle District of Florida lift its preliminary injunction in IBAA v. Conover. This preliminary injunction of February 15, 1985, forbids the OCC from issuing final approvals of over 300 nonbank bank charter applications and preserves the status quo until a decision in the case is reached -- a process that could take years.

In August of 1985, the OCC and opposing parties agreed to a six-month stay of the proceedings in the case until two related cases could be decided in higher courts. Decisions have been rendered in both of those cases, Board of Governors of the Federal Reserve System v. Dimension Financial Corporation (the Dimension case), and Florida Department of Banking and Finance v. Board of Governors of the Federal Reserve System (the U.S. Trust case), supporting the OCC's position.

While these cases do not address the precise issues presented in IBAA v. Conover, the decisions in the Dimension and U.S. Trust cases recognize that nonbank banks are legitimate financial institutions. Consequently, we believe that the preliminary injunction issued by the Florida court is inappropriate, and that is why the OCC has sought to have the injunction lifted.

I believe that we must go forward in this case. We have a responsibility, to the public and to the applicants who have in good faith filed applications for nonbank banks, to have the legal issues resolved on their merits.

SOUTH DAKOTA "LOOPHOLE"

You have also requested my views on the so-called South Dakota "loophole." This so-called "loophole" is a provision of law that authorizes a state-chartered bank to engage in insurance activities outside the state while prohibiting these activities inside the state. To that extent, the statute appears to be inequitable. However, I support the benefits of a dual banking system and believe that great care should be taken in connection with any federal efforts to remove the inequity.

DELAYED FUNDS AVAILABILITY

Also under consideration at these hearings is whether legislation is needed to deal with the funds availability practices of financial institutions.

A financial institution places a hold against a check to protect against the possibility that the item will not be paid. If funds are made available to a customer and the check is subsequently returned unpaid, the financial institution may suffer a loss if the customer has withdrawn the funds and has no other means of covering the check.

Delays in check clearance generally do not arise from the check collection process itself. Although the amount of time it takes to clear a check varies greatly depending on the route it takes through the collection system, check collection has become a highly automated and efficient process. This usually ensures fast clearance.

The process of returning unpaid checks, on the other hand, is not automated and, as a consequence, is slow and expensive. The reason for this disparity is simple. All checks must be collected, so a substantial investment has been made in developing nationwide automated systems for clearing checks. However, less than one percent of all checks are returned unpaid; as a result, a similar investment has not been made in the return items process.

Financial institutions never know for certain if a deposit item has cleared. They get notice only when an item is returned unpaid. Due to the lengthy and variable time required to return items, some financial institutions hold deposits until enough time has passed to make it likely that a deposited item has cleared.

Problems

The practice of setting some holding period for deposited checks is a reasonable practice. However, undisclosed or excessive delays in making funds available to customers can cause embarrassment, inconvenience, and in some cases financial hardship when attempts are made to draw on funds for which credit has not yet been given.

These problems associated with delayed funds availability have two causes. First, because of inadequate disclosure, the customer may not be aware of the depository institution's funds availability policy. Second, the check return process is slow, creating a need for banks to implement check-hold periods to protect themselves from losses that may result from returned checks.

Solutions

These problems call for different, and equally important, solutions. The first is to encourage depository institutions to provide better disclosure. The OCC strongly believes that disclosure of institutions' check hold policies would ensure that the consumer has an opportunity to make an informed decision in choosing among depository institutions.

In the last few years, the OCC has taken two steps to encourage national banks to provide voluntarily disclosures on their funds availability policies. In February 1984, the OCC issued a banking bulletin urging national banks to explain their funds availability practices. The next month, the OCC issued a policy statement on delayed funds availability jointly with the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board. The agencies requested that financial institutions review their policies, refrain from imposing unnecessary delays on all checks, and disclose their practices to customers.

Another solution to the delayed funds availability problem is to improve the check return process. Some progress has been made. In 1985, the Federal Reserve Board amended Regulation J to require payor institutions, within three days of receipt, to notify the bank of first deposit when they are returning checks of $2500 or more. This has encouraged banks to reduce the period for holding checks because the risk of loss is reduced.

The OCC does not view a legislatively prescribed funds availability schedule as a desirable solution. Such an action could, in fact, be detrimental to consumers. If implemented before the check return process is improved, prescribing shorter periods before funds are available may simply force institutions to protect themselves against potential losses in other ways. This could mean higher fees, screening of depositors, or other indirect means of minimizing or offsetting losses. Additionally, requiring shorter periods before funds are available increases the chances that a customer will overdraw an account by writing a check against a deposit that is later returned unpaid.

In sum, the OCC supports disclosure of funds availability schedules by all depository institutions and efforts to remove impediments to fast and efficient return item processing.

EXPANDED BANK ACTIVITIES

Let me turn finally to some of the new opportunities that I believe banks should have to broaden their business activities and diversify the risks they undertake. I commend you, Mr. Chairman, and the Committee for holding early hearings spotlighting several new business opportunities that would allow banks to become more efficient and stable competitors in the global financial services marketplace. The authority to pursue such traditional banking functions as the provision of

short-term credit to commercial enterprises as new products are developed would promote customer benefits and, by increasing the sources for bank income, contribute to the safety and soundness of the financial system.

I believe we need to ensure that the focus of discussion is not on a few new activities or powers, however, but on the appropriate means to protect depositors and the financial system as a whole, while allowing banks the opportunity to regain their competitive strength by delivering the products that the market demands. Instead of an endless debate about this product or that service, our attention should be directed at designing the appropriate legal and operational structure to allow banks needed flexibility while still achieving our public policy goals. Properly regulated, I believe that there are few, if any, business activities that cannot safely be combined with banking.

Securities Activities

The proposals for additional opportunities for banks to participate in the securities business underscore the point that the focus of the debate should be placed on how, not whether, to allow new activities. They also provide an excellent means to demonstrate the urgency of allowing banks greater flexibility.

In statements before this Committee in the last Congress, I detailed a number of changes in the marketplace that have occurred since the 1930s when the laws separating commercial and investment banking were enacted. In particular, I noted that, when the Glass-Steagall Act was passed, short-term credit to the corporate sector was provided almost exclusively by the commercial banking industry. Even as recently as 1965 -- more than 30 years after the enactment of the Glass-Steagall Act -- commercial banks held more than 87 percent of the credit to nonfinancial domestic corporations. By 1984, however, that share had fallen to less than 70 percent. We expect that share to continue to decline. Moreover, the use of commercial paper to finance short-term credit needs has grown at a rate nearly twice that of commercial bank corporate loans outstanding.

Similarly, the structure of the financial services industry has drastically changed during the past few years as customers have sought new products and services from nonbank financial services providers -- most of which are far less restricted than banks in their ability to deliver efficiently a full range of financial services. The reality is that there has been a change in the marketplace that could not have been envisioned by the authors of the Banking Act of 1933. In fact, though the intent of the Banking Act of 1933 was to bring stability to the financial marketplace, those sections known as the Glass-Steagall Act appear instead to be ensuring a slow and steady erosion in the strength of the commercial banking system.

It should come as no surprise, therefore, that I advocate legislation that would give banks the authority to diversify the risks they assume and to restructure their product and service offerings in line with the changing demands of the marketplace. Indeed, there are a multitude of activities that are not currently authorized but are clearly less risky than commercial or consumer lending.

Mr. Chairman, as you and the other members of this Committee are well aware, there is substantial opposition to removing the barriers between commercial and investment banking. The most frequently voiced arguments against the removal of those barriers concern the need to guard against potential conflicts of interest and concentrations of economic power, to protect customers of commercial and investment banks, and to avoid endangering the safety and soundness of the financial system.

Those concerns are largely an unfortunate legacy from the conditions under which the Glass-Steagall Act was passed. Studies have consistently demonstrated that the securities activities of banks had little, if anything, to do with the collapse of the banking system in 1933.[2]

The differences between the legal framework of today and that of 1933 are vast. Restricting securities activities was just one of many initiatives of the 1930s. Other provisions of the Banking Act of 1933 established federal deposit insurance and strengthened the Federal Reserve System. Section 23A of the Federal Reserve Act imposed limitations on transactions between a member bank and its affiliates. Still more concerns were addressed in the Securities Acts of 1933 and 1934 and the Banking Act of 1935.

Significantly, since the 1930s, federal and state supervision of banks has been substantially broadened and improved. Bank regulators have gained and exercised significant enforcement authority, and bank disclosure requirements have been greatly enhanced.

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2. Deregulating Wall Street, Ingo Walter, editor, John Wiley & Sons, 1985.

Consequently, it would be a mistake to assume that expanding banks' securities activities is inherently too risky or fraught with hazards and that expanded securities activities should be flatly prohibited for banks. Rather, as with any banking activity, we simply must ensure that the activities are conducted in a safe and sound manner.

We already have a strong, multi-faceted system of laws and regulations that would prevent most of the abuses cited as justification for denying banks this opportunity to compete. And to the extent that sufficient protections do not exist at present, they can be put in place by appropriate legislation or regulation. Let me cite a few examples of laws and regulations that exisit today.

Conflicts of interest. The potential for conflicts of interest exists in most businesses, including both investment banking and commercial banking. A variety of existing controls have successfully limited the exploitation of such conflicts, and would continue to do so if the Glass-Steagall Act were liberalized. These controls include the securities laws and regulations, the federal antitrust statutes, and statutory controls on bank transactions with affiliates. They also include state and federal laws and regulations governing the actions of fiduciaries. Finally, more information about all businesses is available due to substantial public disclosure requirements.

Economic concentrations. Markets without arbitrary barriers to entry are rarely characterized by unacceptable concentrations of power. The entry of new participants increases competition and reduces concentration levels. It is not surprising that the securities industry, which derives substantially greater protection from the Glass-Steagall Act than banks, is significantly more concentrated than the commercial banking industry. The removal of existing barriers to market entry offers the surest guarantee of continued strong competitive practices in the financial services marketplace.

Protection of bank customers. The protection that laws and regulations now provide to customers purchasing securities services should continue to apply to any provider of securities services, including banks or their affiliates. In addition to protecting customers, those laws would help ensure competitive equity among all market participants.

Riskiness of securities activities. Finally, there exists the belief that some financial activities are simply too risky for banks. Because the ability of banks to accept federally insured deposits and to provide access to the payments system makes them unique, the argument goes, they cannot be allowed to take on additional risks, and therefore, should be prohibited from conducting new activities.

This is an important concern. As the primary supervisor of national banks, I have a duty to see that they are operated in a safe and sound manner. However, it is ironic that many of the prohibitions that are supported in the name of bank safety and soundness are the very prohibitions that substantial evidence indicates have contributed to an increase in the level of risk in the banking system.

Our review of the available information suggests that the risk of securities underwriting is low and very manageable, and certainly lower than the risks associated with many types of commercial lending activities. For example, it has been well demonstrated that, due to short holding periods and a high degree of liquidity, corporate underwriting, for example, is far less subject to losses than is commercial lending. Moreover, underwriting losses are quickly identified and measured -- a benefit to consumers, issuers, underwriters, and regulators.

For these reasons, and because of the efficiencies and stability resulting from such diversification, many countries allow their banks to combine a wide range of financial activities including investment and commercial banking. The banking and financial systems in those countries are now replacing financial centers in the United States as leaders in delivering innovative products and services efficiently and safely. In fact, U.S. banks are conducting an increasing amount of business in foreign markets because of the prohibitions that exist in the U.S. Their performance has not revealed any unusual risk in providing these services.

I noted with interest that Jill M. Considine, New York State Superintendent of Banks, stated recently that "[i]n light of the liberalization of global capital markets, the United States is now at a distinct competitive disadvantage due to the Glass-Steagall Act."[3] In response to this concern, New York State took the the initiative to expand the permissible securities activities that state banks can conduct.

Further, it is worth noting that U.S. commercial banks already have substantial experience in the underwriting of U.S. Government securities, and certain municipal securities. They are permitted to underwrite corporate debt securities virtually everywhere they operate except in the United States. Banks have demonstrated competence in these activities, and I see no reason why they would not fare as well in the underwriting of additional securities domestically.

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[3] Quoted in a New York State Banking Department news release dated December 30, 1986.

Mr. Chairman, for all of these reasons, I support granting banks the authority to provide all of the specific products and services you invited me to address: underwriting commercial paper, municipal revenue bonds, mortgage-backed securities, and mutual funds. I urge the Congress to remove, in addition, those prohibitions that deprive banks of the opportunity to maintain their traditional role as short-term lenders to businesses and deprive consumers of the benefits of greater competition between commercial banks and securities firms.

Commercial banks clearly need to gain greater freedom to adapt to changing marketplace demands as well as an increasingly volatile economic environment. Expanded securities authority is one area where banks could begin to gain this needed freedom. However, we should not stop here.

I urge the Committee to focus not on particular activities, but on the best way to protect the banking function while allowing substantially greater flexibility for banks. Where protections already exist, they should be utilized. Where new protections are needed, they should be adopted. Banks can safely conduct a wide variety of activities, and our efforts should be directed at designing the framework for them to do so.

CONCLUSION

Mr. Chairman, each time the Committee has considered the issues we are discussing this morning, the need for action has grown more serious. Two proposals should command the immediate attention of the Congress: recapitalization of the FSLIC and expanded authority for bank supervisors to deal with failed and failing institutions. Those measures will help sustain public confidence in our depository institutions over the near term.

The questions concerning the role banks will be allowed to play in the financial services markets of the future are no less urgent. Market changes continue to reveal that our current statutory framework is outmoded. Working around these constraints, today's competitors have been forced to choose less efficient corporate structures. In many cases, banks have been denied the opportunity to provide the products and services the market demands. These restrictions undermine the stability of banks and our financial system. Removal of these restrictions would enable banks to reduce their vulnerability to deteriorating loan quality, allow them to increase their reliance on alternative income sources, and enable them to regain their competitive edge as they operate in the global marketplace of today. Finally, greater freedom for banks would provide consumers with the benefits of a competitive financial services industry.

STATEMENT OF

EDWIN J. GRAY, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

I. INTRODUCTION AND OVERVIEW

Mr. Chairman, Senator Garn and Members of the Committee:

Thank you for inviting me to this very important hearing.

Nothing, simply nothing, is more important to the maintenance of a sound financial system than the maintenance of public confidence in it.

In my opinion, that is the real issue we are here to discuss as we approach the issue of recapitalization of the thrift deposit insurance fund.

None of us can afford to forget the nature and consequences of the loss of public confidence which occurred in connection with the Ohio and Maryland thrift crises. The public did, in fact, lose confidence in the backup mechanisms which had been instituted to safeguard the funds of depositors in the Maryland and Ohio systems. And, the repercussions of these thrift cases were felt far beyond the borders of the two states involved.

I believe we must address the issue of public confidence in the nation's federally-insured thrift system with dispatch -- and in a decisive manner which conveys maximum certainty to the public that the problems of the thrift deposit insurance fund, namely the FSLIC, are being dealt with in a way that merits their full confidence in the thrift system. This includes not only the maintenance of adequate financial resources to assure the health of the system but also the commitment and resolve of regulators and legislators alike to assure the integrity of the regulatory process so that federally insured fiduciaries of other people's money employ such funds in a safe and sound and prudent -- yes responsible -- manner.

We are not here today because of the kinds of problems which beset the FSLIC back in 1981 and 1982 when the costs of money being paid by thrifts was rapidly exceeding the return on largely lesser-yielding fixed-rate mortgage assets. The thrift insurance fund was able to deal with those kinds of problems at relatively far less cost. Since then, interest rates have receded very substantially.

Today, the underlying problem is that of poor quality assets which, in too many cases, have resulted from risky loans and highly speculative investments which have gone sour. Many of these assets at severely troubled institutions did not come about because of the energy problem in some states. They were bad assets before the price of oil tumbled. The effect of oil prices on some economies merely further exacerbated the difficulties involving such assets.

In this connection, we are exercising considerable discretion in our efforts to work closely and constructively with responsible thrift institution managements that are operating in depressed economies, particularly in the southwest. We are taking into strong account the nature of the difficulties they face in such economies, and where we reasonably can we are seeking to exercise appropriate forebearance, especially in cases where there is good management and the likelihood that such institutions can be turned around and restored to health.

I want to emphasize that roughly four out of every five FSLIC-insured institutions are operating profitably. The latest figures we have, for the first three quarters of 1986, show that the profitable sector of the industry earned $6.9 billion for that period, which is only $500 million less than the earnings of the profitable sector of the business during all of 1985.

On the other hand, the unprofitable, and therefore troubled, sector of the industry -- that is to say, roughly one-fifth of the industry -- ran up losses in the first three quarters of 1986 of $5 billion, up from $3.6 billion for all of 1985.

Nevertheless, the fact is the profitable sector -- the vast majority of the industry -- is highly profitable. This is a fact everyone must keep fully in mind as we approach the issue of FSLIC recapitalization. Despite suggestions by some that the thrift industry is "on the rocks" and "going down the tubes" the facts belie such "doom" scenarios. Again, the profitably of the vast majority of the industry tells me that the industry is worth saving.

Because the profitable sector of the industry must bear the brunt of depositor perceptions about the unprofitable sector, the industry as a whole is paying far higher rates for deposits than it otherwise would or should. Indeed, a study we completed last year showed that the thrift industry as a whole was paying at least $4 billion a year more than necessary, precisely because of market concerns about troubled thrifts and negative perceptions of the FSLIC deriving from its weakened condition. The higher rates paid for deposits by the industry -- and all institutions, healthy or unhealthy, are affected -- come right off the bottom line and therefore hurt the profitability of the industry as a whole.

The spillover effects of a weak, thoroughly inadequate thrift deposit insurance fund, which is incapable of resolving severely troubled, terminally-ill thrift cases because it doesn't even begin to have the financial resources to do so, is affecting public confidence in the thrift system as a whole in a detrimental and an all too pervasive manner.

The public is clearly very much aware of the inadequate resources of the FSLIC and, as a result, the entire thrift industry is paying a heavy price in the premium rates it must offer to attract and retain deposits. Severely troubled thrifts, so long as they remain open, have no choice but to continue their operations with exceedingly high-cost deposits if they are to maintain liquidity. This is a self-defeating proposition because the higher the cost of such operating funds, and by this I mean deposits, the more difficult it is to reach profitability, hence the higher likelihood of such cases ultimately requiring FSLIC assistance.

Both the FSLIC and Federal Home Loan Banks are directly affected by the liquidity needs of seriously troubled thrifts. In an effort to lend these thrifts funds to maintain liquidity, the Federal Home Loan Banks require that the loans ("advances") be guaranteed by the FSLIC. There are $3.6 billion in FSLIC-guaranteed advances outstanding but only $1.6 billion are secured by collateral from the thrifts. This means there is no security behind $2 billion in such FSLIC guaranteed advances except the primary reserves of the FSLIC, itself. Since the FSLIC has only $1.9 billion in primary reserves, a call on these advances by the Federal Home Loan Banks would wipe out the primary reserve. This demonstrates the non-existent margin between FSLIC-guaranteed advances and current primary reserves which guarantee such Federal Home Loan Bank advances. Indeed, another $2 billion in requests for FSLIC-guaranteed advances are pending. If approved, they would raise the uncollateralized portion of such FSLIC-guaranteed advances to over $3 billion, more than a billion dollars more than currently exists in the primary reserves of the insurance fund.

The 347 thrift institutions currently in our significant supervisory caseload, which includes 167 FSLIC cases, are losing $6 million a day, every day of the year, on an operating basis. These operating losses total $2.2 billion, more than the FSLIC's 1986 income. Thus, without recapitalization of the thrift insurance fund, the FSLIC can hardly "tread water," let alone resolve cases of failing institutions.

Early in 1985, the Bank Board, in its role as operating head of the FSLIC, commenced the full exercise of its statutory authority to augment the reserves of the fund by assessing a "special (premium) assessment" on all FSLIC-insured institutions. This assessment, which amounts to 1/8 of one percent of deposits, added a billion dollars to the fund's reserves in 1985 and $1.1 billion in 1986. The special assessment is in addition to the regular premium paid yearly by insured institutions. The regular premium is 1/12 of one percent of deposits. It provided the FSLIC $704 million in 1985 and $748 million in 1986.

As mentioned previously, the primary reserves in the fund today stand at $1.9 billion. Today, the ratio of primary reserves-to-deposits is 21 one hundredths of one percent, an all-time low.

From early on in my tenure at the Bank Board, I have sought to keep the Congress and the thrift industry apprised of the weakening condition of the insurance fund, including the steadily deteriorating reserves of the fund and the declining ratio of FSLIC reserves-to-deposits. Some in the industry have, over the course of my time in office, admonished me not to talk about the fund's weakening condition, apparently in hopes that by sweeping the problem under the rug it would somehow go away. I did not take that advice.

Indeed, I have warned repeatedly since late in 1983 of my deep concerns about the worsening condition of the thrift fund.

In the late summer of 1985, after coming to the conclusion that the additional "special assessment" would not be sufficient to deal with the FSLIC's problems out into the future, I called for a recapitalization of the fund during a formal speech before the Annual Convention of the California League of Savings Institutions. In October, 1985, I testified to the Congress that the fund would have to be recapitalized and that the only two sources I knew of were the thrift industry or the taxpayers. I have continually opposed the notion of a taxpayer bailout.

In early January, 1986, I appointed a task force of the Federal Home Loan Bank presidents to develop a plan to recapitalize the fund, utilizing available financial resources of the Federal Home Loan Bank System and the industry, in combination. What emerged then still constitutes the basic outlines of the Bank Board-Treasury recapitalization plan which was first presented to this Committee in March of 1986. The plan, in different forms, passed both Houses of the Congress in the last days of the 99th Congress. However, final action was delayed. On January 6 of this year, the Chairman of this Committee and Senator Garn jointly introduced S.45 by request. This bill incorporates the same basic FSLIC recapitalization framework approved by both the Senate and the House last year.

The Bank Board-Treasury plan is intended to provide sufficient resources over the next five to seven years to resolve the terminally-ill thrift cases which we know about or can reasonably expect over that period.

Last Spring, I estimated the cost of resolving known cases requiring FSLIC assistance to be in the neighborhood of $16 billion. A good deal of work has gone into a revision of last year's estimate and we now put the known cost at $19.5 billion. There are borderline cases, however, which I want to add to this estimate which would bring the total to $23.5 billion.

I must emphasize that these are estimates. No one can know with certainty in advance what the actual cost of resolution to the FSLIC will be over time. But I am comfortable that these are good faith estimates based on very considerable relevant supervisory and financial data. Clearly a significant rise in interest rates, or other unforeseen economic circumstances in the future, could affect any current estimate.

The overall plan to recapitalize the thrift insurance fund which we have proposed contemplates -- if necessary -- as much as $32.5 billion for resolving terminally-ill thrift cases over the next seven years. Thus, the plan provides another $9 billion to deal with additional, now unknown contingencies, if they develop, above and beyond the estimated $23.5 billion which could possibly be needed to resolve cases, as described above. How the plan works is summarized in Section II (page 13) of this statement.

In focusing on the recapitalization issue, it seems to me we also should focus on the future of the thrift industry, itself, and the statutory system which the Congress has put in place to both govern its public purpose, consistent with the intent of law, and to regulate for safety and soundness, pursuant to statute and regulatory standards.

Replete within the body of federal law enacted over the years is the clear and unmistakeable message that the thrift system exists to serve a public policy purpose -- a purpose which is significantly different from that which governs the commercial banking system. The clear public policy purpose for the thrift system, as set forth in statute, is to serve the principal public policy goal of financing housing and homeownership. This is, by no means, the sole reason for the separate existence of the thrift system but it is -- pursuant to the intent of law -- the principal reason. If it were not, and if thrifts were intended to play the same identical role as commercial banks, then there would be little apparent reason for the maintenance of a separate and distincct statutory-based thrift system.

The Congress devised, and has continuously supported the idea behind the separate existence of the thrift system for more than a half century, evidently because it has believed that relatively specialized financial institutions with a particular expertise in housing finance serve to effectively support the public policy goal of maximizing homeownership opportunities for American families.

Indeed, at the end of 1986, thrift institutions held in their portfolios more than half the residential mortgage debt in the country, or nearly three quarters of a trillion dollars.

Thirty percent of the nation's mortgage backed securities were not held by private investors, pension funds, insurance companies, etc., but, yes by thrifts, to the the tune of $156 billion at the end of 1986. During 1986, insured thrift institutions originated half of the home mortgages in the country, compared to 19 percent by commercial banks.

To facilitate the purposes of the thrift system, the Congress created a separate central banking structure for thrift institutions in the form of the 12 regional Federal Home Loan Banks. These government-sponsored instrumentalities of public policy lend funds ~~(we call them~~ ("advances") of varying maturities, including long-term funds, to thrift institutions at preferential rates. The Federal Home Loan Banks also fully pay the costs of the front-line regulatory system, namely examination and supervision, for the purpose of assuring compliance with statutes and regulations -- including insurance regulations which are intended to safeguard the resources of the thrift deposit insurance fund. Notably, this insurance fund was established by the Congress under the authority of the National Housing Act.

In 1982, the Garn-St Germain Act consisted, in significant part, of amendments to the Homeowners Loan Act of 1933. My own understanding of the intent of the Garn-St Germain Act is that it was intended to maintain the essential traditional public policy purpose of the thrift system, that of principally serving America's housing finance needs. In order to do this, the Congress felt that thrift institutions ought to have significantly more bank-like lending and operating flexibility to more effectively support their basic, or principal mission, of providing funds for residential housing finance. Some states have gone well beyond what Congress appears to have intended in this regard by providing their own state-chartered thrifts far more expansive lending, investment and operating authorities.

Still, the body of law enacted by the Congress up to now for the thrift system is clear in its emphasis on housing finance as the principal public policy justification for the continued existence of a separate and distinct statutory thrift system. Some may not agree with that emphasis but, in my mind, that seems to be the intent of Congress in the statutes -- which I am sworn to uphold and carry out.

Some in the financial community argue that the thrift system has outlived its usefulness, that it is obsolete in the emerging financial services environment, and that the thrift deposit insurance fund ought to be "merged" with the FDIC fund.

They recognize, as you must, that a so-called "merger of the funds" would signal the beginning of the end of the thrift industry and the statutory thrift system, and in my opinion, they are basically correct in this regard.

Those who talk of "merging" the thrift and commercial bank deposit insurance funds surely cannot expect to be taken literally. I do not believe there is any chance, whatsoever, that the Congress would seriously consider "merging," that is to say "comingling" or "integrating" resources of both funds into a single deposit insurance fund at any time in the foreseeable future because such a comingling of the dollars available in one fund is simply not politically feasible.

In "merging " -- yes, "comingling" -- the finances of both insurance funds into one, under the governance of the FDIC, such a pooling of finances would thence be called upon to pay for both thrift and commercial bank failures. Again, I do not believe this is politically feasible. Beyond the political consideration, such a merger would only serve to weaken the resulting, integrated and comingled common deposit insurance fund because its obligations to pay for losses would be far greater, without a commensurate increase in its reserves.

Those who talk of a "merger of the funds" surely must really be talking about a transfer of the current governance of the thrift deposit insurance fund from the Federal Home Loan Bank Board to the Board of Directors of the FDIC. Were this to be the case, it would not constitute a "merger of the funds" at all, but rather a consolidation of the governance and management of two separate deposit insurance funds under one board of governors. And, if this were the case, recapitalization of the thrift fund would still be necessary in order for the new management of the thrift fund, namely the board of governors of the FDIC, to resolve thrift failures and meet obligations to thrift depositors.

The issue of which board of governors should oversee and manage the thrift fund does indeed have profound, historic implications for the future of the thrift system, as I suggested earlier. The FDIC, which serves as the deposit insurance arm of the commercial banking regulatory apparatus, and which exercises authority over some 14,000 commercial banks in this country, is basically oriented toward an industry which generally is quite different from the more specialized nature of the thrift industry. This suggests, to me at least, that such an orientation, if the FDIC were to govern both insurance funds, would subsequently lead to a consolidation of the thrift regulatory and credit (Federal Home Loan Bank) apparatus with -- that is to say, into -- the commercial banking system apparatus. Thus, if my instincts are correct, the consolidation of governance of both deposit insurance funds under the FDIC would not merely represent a "change of control" over the thrift insurance fund but would definitely signal a profound change in direction for the depository institutions system in this country -- namely that any statutorily-based system primarily oriented toward specialization in home mortgage finance might well be seen as significantly less relevant to meeting public needs in the future.

The Congress could, of course, establish a new and different public policy rationale to justify the continued existence of a separate "thrift" system, but that too might well signal a major departure from its longstanding support for a rather more specialized housing finance system within the overall depository institutions structure of the nation's financial system.

Whether the Congress chooses, at any time, to consolidate governance of the two deposit insurance funds under the FDIC is a call the Congress and the President will have to make. I hope the recapitalization issue doesn't get us to that point, but rather that our recapitalization plan moves us in the opposite direction.

Regardless of how that comes out, recapitalization of the thrift deposit insurance fund is, and will be, necessary in any event. In my view, the Bank Board-Treasury plan -- though not perfect, but what is? -- is far superior to any other plan of which I am aware.

I believe very deeply that recapitalization of the thrift insurance fund requires a trade-off -- that is to say, deep commitment and resolve on the part of regulators and leaders in the Congress to assure that effective measures are put in place to halt future hemorrhages, resulting from new cases, in order to give recapitalization the best chance to succeed. Indeed, without such future resolve and commitment, the likelihood of such success is at the very least questionable.

What is really called for, in this regard, is courage.

Regulatory initiatives to assure safety and soundness are often controversial in the thrift industry. Some members of the Congress sometimes bring substantial pressure to bear on regulators to relax or even withdraw regulatory initiatives intended to strengthen safety and soundness in the industry. In my opinion, what they ought to be saying to us is: "You take the heat. We'll back you up. Do what you have to do to make the system work."

It seems to me that any commitment to recapitalize the thrift insurance fund by the Congress, itself, does, indeed, require a corollary commitment to maintain the viability of the plan by maintaining the true integrity of the regulatory process. During my tenure in office, most of the regulatory actions taken by the Bank Board, in its role as operating head of the thrift insurance fund, have been intended to promote safe and sound and prudent thrift operating practices, and thus reduce the risk of loss, as well as actual losses, to the insurance fund.

When thrift deregulation, on both the asset and deposit side, went into effect a few years ago, the regulatory apparatus in the Federal Home Loan Bank System was simply unprepared to effectively manage the new risks deregulation brought with it. In the face of considerable obstacles over time, the Board has nevertheless made considerable progress in overhauling and modernizing the regulatory apparatus to better assure that safe and sound operating practices are observed in the industry. The Board has taken positive, forward steps to move the industry toward common accounting and capital standards with the commercial banking sector. But more remains to be accomplished.

Throughout my tenure, I have worked hard to implement important reforms to encourage continued safe and sound operation in the deregulated thrift environment. One of the most important accomplishments of the Board has been the strengthening of the oversight function, namely examination and supervision. Today, we have over 1,500 field examiners throughout our system. That is twice as many as we had just a year and a half ago. In little more than two years, we have tripled the size of our professional supervisory staff throughout the 12 Federal Home Loan Bank ("FHLBank") districts.

I also have strongly advocated higher thrift capital standards that move us strongly in the direction of commercial bank requirements. Last August, the Board adopted a new capital rule that requires all FSLIC-insured thrifts to increase their net worth to the six percent range over a phase-in period tied to industry profitability. The new rule also incorporates a risk-based formula. Thrifts must post added capital for riskier investments, such as acquisition and development loans. Similarly, the rule permits reductions based on effective interest-rate risk management.

The Board has also moved significantly in the direction of requiring institutions to report to us using generally accepted accounting principles. In 1984, we did away with loan loss deferrals for accounting purposes on a prospective basis. Five-year averaging and twenty-year phase-in of regulatory capital are gone. Further appraised equity capital treatment for thrift offices and branches has expired.

We are moving quickly to improve the FSLIC's ability to use the funds that recapitalization could provide. Last year we initiated an in-depth review of our FSLIC case resolution and receivership operations. Based on the findings of that review, I have charged a system-wide Task Force to present recommendations and implementation plans to the full Board within the coming month. The Task Force has been asked for:

-- Implementation procedures to support a recommendation for delegation to the regional Federal Home Loan Banks of the staffing for FSLIC case resolutions;

-- Implementation procedures to support a recommendation for stronger Board oversight of FSLIC receiverships; and, the fullest possible use of the Federal Asset Disposition Association (FADA) for both FSLIC asset analysis, and the management and disposition of receivership assets;

-- Implementation procedures to support a recommendation for a complete restructuring of the case resolution process to provide more timely due diligence reports, earlier decision-making by the Board, and a revamped national marketing program;

-- Implementation procedures to support a recommendation for the creation of regional counsels at the Federal Home Loan Banks to provide legal support for local Bank case resolution staff work;

-- Implementation plans to support a recommendation for the creation of new budget, case planning, cash management, and audit review procedures for FSLIC. The evaluation of FSLIC staff performance and bids for the acquisition of institutions will now be judged under a completely revised system which capitalizes the holding cost of assets in determining benchmarks for adequate recovery of value; .

-- Implementation procedures for a new management information system -- including regular and exception reporting -- to support broader Board delegation of FSLIC functions. This recommendation will require the development of standardized FSLIC procedures for the bid valuation process, for due diligence reports, for all case analysis, for bid package preparation, and for post-audit reviews.

We expect to start the process of implementing these reforms within 60 days. I am confident that the proposals I have just described will permit the Board to give timely and accurate reports to the Congress of our disposition of FSLIC funds. I further expect that these reforms of the FSLIC case resolution and receivership procedures will insure the maximum recovery of value for the FSLIC fund by using fully the regional resources of the Federal Home Loan Banks, the organizational expertise of FADA, and focusing the work of our FSLIC central staff on case planning and budgeting, policy oversight and post-audit review.

In my role as regulator, I have not pandered to the industry, and most particularly to the high risktakers, the high rollers and daredevils, who through their greed and lack of prudence in operating federally-insured savings institutions have created huge losses, and prospective losses, for the thrift insurance fund. On the contrary, I have sought, with some considerable opposition at times, to put in place rules which I have believed would lessen the risk of loss to the insurance fund, without unduly restricting sound opportunities for thrift institution profitability.

Recently, the Bank Board extended its direct investment regulation for only several months. While I do not believe the regulation is as strong as it ought to be, it does, in my view, embody an important regulatory concept. It establishes a supervisory review threshold which cannot be exceeded without regulatory approval. I would hate to see a commitment to recapitalization of the thrift insurance fund without a concurrent commitment to the safety and soundness principles this regulation seeks to address. In the absence of appropriate extension of this regulation by the Bank Board, I request that, at a minimum, the language of the regulation be included in any legislation to recapitalize the thrift insurance fund for at least a period of two years.

As you know, the Chairman of the Federal Reserve Board and the FDIC support this regulation. In late 1985, the House Committee on Government Operations praised the regulation for its flexibility and called it "a prudent precaution while the FSLIC is in a weakened condition." On December 16, 1986, I sent members of this Committee a letter relating the Bank Board's three-year experience with high levels of direct investments in a number of failed or failing thrift institutions and the exceedingly high cost to the FSLIC to resolve those cases. Our own staff studies show that for failed thrift institutions, each dollar of direct investment increases the cost to FSLIC by from 60 to 85 cents on the dollar.

At a time when we are talking about the state of affairs which has brought us to the critical issue of FSLIC recapitalization, this is no time to temporize on the direct investment issue. In my mind, the recapitalization of the thrift fund makes little sense if we fail to deal with the direct investment issue and its impact on the reserves of the FSLIC.

The effort I have undertaken over time to restore discipline and safety and soundness principles to the thrift system must continue. Call it "re-regulation" if one feels compelled to do so, but there is simply no substitute -- by whatever name -- for safety and soundness if recapitalization of the thrift insurance fund is to be effective in both the short and long term. Without appropriate discipline in the thrift industry, and a recognition on the part of everyone that safe and sound thrift operations are the key to the thrift industry's future, any plan to recapitalize the thrift insurance fund can only end in ultimate failure. A hemorrhage of losses to the thrift fund from a spate of new thrift failures (above and beyond anticipated resolution costs) out of failure to insist on, and yes demand, that thrift managements operate their institutions safely and soundly and prudently, would be a self-defeating phenomenon.

Hence the need for greater regulatory discipline, to assure that safe and sound thrift operating practices do prevail in the future, and a strong realization on everyone's part that protecting the future reserves of the fund is, in the deepest sense, truly in the public interest, because it is the taxpayers of this country who ultimately stand behind the thrift deposit insurance fund.

II. THE FHLBB-TREASURY PLAN TO RECAPITALIZE THE FSLIC

The crux of the proposal has not changed from that outlined in early 1986. It allows the use of the retained earnings of the FHLBanks to serve as seed money for a new government corporation (the "Financing Corporation"), which would leverage the seed money to borrow from $10 to $15 billion over the next few years. The Financing Corporation would then use these funds to purchase stock in the FSLIC. We estimate that, over the next five to seven years, the FSLIC would obtain capital of from $25 to as much as $32.5 billion from its sale of stock to the Financing Corporation, premium collections, income from the disposition of assets under receivership, and income from its investments.

During the next five to seven years, the FHLBanks would contribute to the Financing Corporation as much as $3 billion of their retained earnings. The FHLBanks' retained earnings, as of December 31, 1986, aggregate in excess of $2 billion. Even assuming slow economic growth, within five years or so these retained earnings are expected to grow to approximately $3 billion.

The Financing Corporation would operate in two concurrent modes -- as a funding corporation and in a sense, as a trust. It would have all the same attributes as a government agency operating in the capital markets. That is it would be deemed a safe, high quality security utilized for a high public purpose and thus eligible for purchase by various trusts and fiduciaries. However, its debt would have no guarantees from the Treasury or the FSLIC. Further, it would have no paid staff of its own, but would utilize the existing staff resources of the FHLBank System. The Financing Corporation would sunset by 2027.

The Financing Corporation's borrowings would take the form of collateralized long-term bonds. It could access the capital markets, as the FSLIC's needs dictated, over the next five to seven years. For example, if the FSLIC's resolution costs over that period are less than the roughly $23.5 billion we anticipate, the Financing Corporation would simply use fewer FHLBank retained earnings as seed money for borrowing in the capital markets. This flexibility allows the plan to deal with resolution costs on an "as necessary" basis.

Payment of the principal and interest on the bonds would be the sole obligation of the Financing Corporation. Importantly, no payment would be guaranteed by the U.S. government. Payment of the principal amount of the bonds would be assured, because the principal would be fully collateralized at maturity with government securities held in trust for that purpose. The

Financing Corporation would purchase this collateral with a portion of the funds it receives from the FHLBanks. Over 25 to 30 years, the term of the bonds, continuing return on the collateral would compound enough interest to assure payment of the principal amount of the bonds. Such investment returns are most easily assured by the purchase of zero coupon bonds, but other means are also available.

Investors also could reasonably expect prompt payment of interest on the bonds of the Financing Corporation. Interest would be paid with funds from two sources: (1) a reserve funded with a portion of the funds contributed by the FHLBanks and (2) dedication of a portion of the FSLIC premium stream from insured institutions. To prevent a "double whammy" to insured institutions the bill reduces FSLIC's premium assessment authority by any debt service the Financing Corporation incurs.

Advantages of the Proposal

The proposed bill produces several important benefits. First, the FSLIC would be able to employ as much as $32.5 billion over seven years -- if necessary -- to resolve its case load of terminally-ill thrifts. This would halt expansion of the FSLIC's problems and boost depositor confidence in the FSLIC, the thrift system, and the overall financial system. Most important, the taxpayers would not spend a penny for the cost of recapitalization. The cost would be borne solely by the FHLBanks and FSLIC-insured thrifts without any government guarantee of Financing Corporation debt. Third, the flexibility built into the bill permits the Board to raise gradually a range of funds for the FSLIC -- as needed to resolve cases involving terminally-ill thrifts. Additionally, the bill is structured carefully to create budgetary receipts from the equity investments in the FSLIC that will offset budgetary outlays resulting from the FSLIC's case resolution costs.

From the industry's perspective, renewed public confidence plus the sale, merger, or liquidation of the weakest thrifts should help the industry lower its cost of funds. The cost differential that thrift institutions pay over that of commercial banks is in excess of $4 billion a year. In addition, the bill provides for the FSLIC recapitalization burden to be shared fairly between the thrifts and the FHLBanks, with contributions structured to minimize the adverse effects on both. It must be kept in mind that the FHLBanks will still be able to economically provide long-term funds to many of the smaller thrifts which cannot access these markets themselves.

Ability of the FHLBanks to Provide Seed Money

The FHLBanks, whose stock is wholly owned by member savings institutions, derive their income from the advances and other services provided to their member savings institutions. In 1986, The CHAIRMAN. Thank you, Chairman Gray.

Chairman Seidman.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman. We welcome you as chairman and your devotion to getting something done this year. We certainly support you.

In the interest of time, I will summarize my summary.

The CHAIRMAN. Without objection, your full statement will be printed in the record.

Mr. SEIDMAN. Thank you. And if you are giving out dispensations for that, we'll take either our cars or exemption from apportionment. [Laughter.]

Given that, I can just say with respect to the FSLIC recapitalization that we support everything that Chairman Gray and Secretary Gould have said. The particular merit of the plan is that it provides the resources of the industry itself to save itself. It seems to me if they want to be a separate industry, it ought to do that; and we urge you to give that the highest priority.

With respect to our emergency acquisition powers, I would like to make three points.

SIZABLE INCREASE OF BANK FAILURES FOR 1987

The first one is that we expect for 1987 a sizable increase in bank failures, above the 145 that we had in 1986. That means we are going to be under considerably greater pressure to find purchasers for failed banks and we can find purchasers many times across State lines when we cannot find them locally. And we have gone from 80 percent of P&A's or purchase transactions to 68 percent in the last year and, therefore, it becomes increasingly urgent that we have these additional powers.

Now we know that our prior proposal was made before a great many States acted to allow interstate acquisitions, but we still have a number of States where there are substantial numbers of problem banks that have not acted, including Colorado, Iowa, Kansas, Nebraska and Wyoming; and those had approximately one-third of the failures during the past year.

So the actions of the States have not taken care of the problem sufficiently.

Finally, most of the banks that are going to fail are going to be well below the recommended size limitations of $250 million or the previous statute of $500 million. We recommend, if we are going to move forward with this legislation, that we eliminate or substantially eliminate the size restriction on the FDIC.

We again ask that the apportionment problem be straightened out. We don't see any reason for a 36-year-old statute suddenly being applied to us and we would also like to strongly recommend S. 288 introduced by Senator Riegle which will help us with one of our most important problems, and that is recruiting of a quality staff of examiners.

With respect to nonbank banks, our conclusion is that at their present size they have not been a problem to the system. No nonbank bank has failed and they represent less than 2 percent of the banks on our problem list, and they play a relatively small part in the system.

Nevertheless, we believe that the present statutory system is inequitable and needs to be changed not only because it is unfair but because it will strengthen the system. Unfortunately, just closing the nonbank loophole won't address the real problem. Significant inequities will continue with grandfathering, unitary thrift holding companies, et cetera.

So, if we're going to deal with this problem, we ought to deal with it on a broad basis. We believe that all institutions enjoying the privilege of Federal deposit insurance should operate under the same regulatory rules and ownership restrictions. If the restrictions are appropriate for one, they are appropriate for all.

With respect to powers, I subscribe to everything that Chairman Volcker said. I can't add anything to it. We are in complete support of his position.

With respect to check holding, we believe that legislation is necessary. I say this because my wife has run afoul of this several times and I will not be able to go home unless I support it. [Laughter.]

We are strong believers that something has to be done about that.

I thank you for listening to me, Mr. Chairman, and I await your questions.

[The complete prepared statement follows:]

the FHLBanks earned $1.4 billion and paid out over $900 million dollars in cash and stock dividends. At December 31, 1986, the FHLBanks had an aggregate of $131 billion in assets and $11.7 billion in capital with total retained earnings of $2.3 billion; making it one of the strongest financial institutions in the world.

Given the level of retained earnings and income, we expect that the FHLBanks could provide $3 billion to the Financing Corporation over the next several years. This amount in relation to its extremely strong capital base insures that FHLBank debt would be protected from possible higher borrowing spreads.

Phase-Out of Special Assessment

Finally, the industry will benefit because the recapitalization funding will permit the FSLIC to phase out its special (premium) assessment. Under our current assumptions, the special assessment could be phased out gradually over five years. We believe such a phase-out of the special assessment provides the many healthy institutions an opportunity to see "a light at the end of the tunnel" with respect to that costly, but now necessary, burden.

Exit Fees

In short, I believe that this plan represents the most feasible and cost-conscious method to assure the continued strength of both the FSLIC and the thrift industry. No responsible person, however, can ignore the fact that the plan's ultimate viability depends on reliable revenue projections. The plan can work over its projected life only if we take into strong account now the need to maintain a growing deposit base in the industry to support FSLIC's activities. However, some members of the industry have threatened to change their charters and abandon the FSLIC insurance system, thus avoiding the payment of FSLIC insurance premiums.

To avoid any doubts that might undercut the plan's overall design or investor confidence, I believe the best approach is to devise an express statutory safeguard to limit erosion of the FSLIC-insurance premium-paying base. The National Housing Act currently authorizes the FSLIC to charge a fee against institutions that voluntarily leave the FSLIC insurance system. As you know, the FSLIC has been assessing "exit fees," but recent litigation may have a chilling effect on the flexibility I believe the FSLIC urgently needs. I propose that the bill under consideration be revised to reaffirm and expand the authority of the FSLIC to impose fair and reasonable "exit fees." In my view, adopting appropriate language to reaffirm our authority in this regard is crucial to maximize the long-term success of recapitalization.

It is our view that such exit fees should not impose an insurmountable barrier to those who may choose to leave the FSLIC for this or other legitimate business purposes. However, the exit fee must roughly cover in present value terms the lost premium stream over the early years of our plan, when it is more vulnerable. Some of our exit fees to date have been designed with these dual objectives in mind. We will soon provide you with a proposed amendment to the bill to address this problem.

Risks

Finally, I cannot overstate the urgent need to adopt the recapitalization plan as soon as possible. Waiting six months or more could fatally harm our plan by eroding consumer and investor confidence and further imperiling the FSLIC. To summarize these risks:

o The major risk of delayed passage jeopardizes the guaranteed advances program of the FSLIC and could precipitate a liquidity crisis or drive up the cost of retail deposits. As previously mentioned the FHLBanks have made roughly $3.6 billion in advances to thrifts that are FSLIC cases, on condition that the FSLIC guarantee these loans. Another $2 billion in such advances has been requested at this time. If these advances are not made and some of the outstanding $3.6 billion not renewed, it would require the institutions to aggressively compete for what are clearly high cost retail deposits, thereby increasing costs for themselves and other institutions in their markets. Some institutions would be forced to seek emergency funds directly from the FSLIC, placing a greater strain on the slim primary reserves of the FSLIC.

o The ongoing operating costs of failing thrifts that the FSLIC cannot afford to close is mounting by over $6 million a day or almost $2.2 billion a year. We are hardly even able to "tread water" if we don't close costly and terminally-ill cases as soon as we can.

o Further delay may well jeopardize the ability of the recapitalization plan to go forward. The plan can succeed only if capital market funds are obtained at a reasonable cost. Investor concerns about the continued weak state of the FSLIC and the ability of Congress to deal with it could undermine confidence to the point where such bonds would be very costly. If such uncertainity arises to this point the plan could become infeasible for two reasons: (1) debt service could exceed premium income or (2) the investor base could shrink as those constrained to high quality investments withdraw. This would prevent raising sufficient funds for resolving cases.

- Finally, delay would sharply increase costs due to the loss of certain tax provisions that now reduce FSLIC costs, as such provisions are scheduled to expire December 31, 1988.

III. EXPANDING FSLIC FLEXIBILITY

The Committee has also asked for my comments on reenacting the emergency provisions of the Garn-St Germain Act of 1982, and closing the "nonbank bank" loophole. Both actions would vitally reduce FSLIC resolution costs by encouraging investor interest in failing thrifts. I also strongly support both of these measures as an important corollary to recapitalization.

A wide variety of investors, commercial banks, industrial firms, insurance companies, as well as "nonfinancial" organizations are encouraged to submit bids to acquire failed institutions in order to minimize expenditures to the FSLIC.

Two difficulties the Bank Board faces in finding serious acquirers for its FSLIC cases are the poor asset quality of most troubled institutions and the high cost of the "hot" money funding their portfolios. These problems of poor asset quality and high liability cost have substantially offset the interstate franchise value of failed thrifts. The continued existence of the nonbank bank phenomenon also erodes the franchise value of such thrifts.

Nonbank Banks

The first involves dealing with the nonbank bank issue. I have never taken a position on the merits or demerits of nonbank banks, as such. My concern has been limited to the manner in which the existence of nonbank banks hinders entities from acquiring troubled thrifts because such entities have far less expensive access to nonbank bank franchises. Before the nonbank bank phenomenon, the FSLIC was more successful in reducing its costs by offering acquirers the incentive of interstate franchises. It is impossible to know precisely what effect this loophole is having on the FSLIC's ability to resolve severe problems, but bidders who were willing to negotiate seriously to acquire a failed thrift to achieve interstate operating rights have become much harder to find. As a result, the FSLIC must up the ante and further deplete its own resources to resolve troubled cases.

Accordingly, I believe it is important to the health of the FSLIC to enact legislation to close the nonbank bank loophole, once and for all. At a time when the FSLIC fund is dangerously low, the FSLIC needs the unhampered ability to offer valuable non-cash incentives to potential acquirers. For this reason, I also am opposed to any grandfathering for existing nonbank banks.

Garn St Germain Emergency Powers

The second needed legislative action is extension for three years of the emergency provisions of Title I of the Garn-St Germain Act. Reenactment is critical to avert further erosion of the FSLIC's reserves, and to complement and maximize the FSLIC's efficient use of funds provided through recapitalization. These emergency provisions were originally adopted in 1982 to give much needed flexibility to the Board and the FSLIC in light of the demands at that time on the resources of the FSLIC. Today, these provisions are needed even more.

Failure to reinstate the emergency powers of the Garn-St Germain Act would severely hamper the Board's ability to deal effectively with the current demands on the FSLIC's razor-thin finances. The lapse of these emergency provisions has created large gaps in our statutory scheme that impair and complicate our mission of devising innovative and expeditious solutions to the major problems facing the FSLIC. The availability of these tools is also imperative to make our recapitalization plan fully successful by maximizing FSLIC's tools for reducing case resolution costs.

Emergency Acquisition Authority

First, Congress should reenact section 123(a) of the Garn-St Germain Act (408(m) of the National Housing Act), which granted the FSLIC power to authorize mergers and acquisitions of failing thrifts by a wide variety of acquirers across state and industry lines, notwithstanding conflicting state or federal law. Since enactment of the Garn-St Germain Act, the Board has authorized acquisition of 76 failing FSLIC-insured institutions involving interstate, interindustry, and related legal issues that would have prevented such supervisory action without the override authority granted by section 408(m).

Reviving such emergency authority is especially important to reduce FSLIC outlays now and under a recapitalization plan. While in effect, section 408(m) increased the universe of firms legally eligible to acquire troubled thrifts, and injected greater competitiveness into the assisted merger bidding process, reducing FSLIC assistance outlays, and lessening the likelihood of liquidations. Restoring this authority will offset significantly the problem of diminished investor investment in failing thrifts.

Two recent changes to the tax law make it even more essential to expand this pool of eligible investors and to finalize supervisory acquisitions within the two year grace period before these provisions take effect. One provision removes tax exempt status from FSLIC financial assistance for supervisory acquisitions. The other provision removes the ability of acquiring institutions to use loss carryforwards in mergers with troubled institutions. The likely practical effect of these provisions is to reduce dramatically the number of potential acquirers, to raise the cost of attracting acquirers, and to force the FSLIC to liquidate an increased number of institutions for which mergers are no longer feasible.

To further enhance FSLIC's ability to obtain the highest bid from an expanded bidder pool, I support eliminating the restrictive bidding procedures and preferences of section 408(m). I believe that this bidding process has perhaps had the unintended effect of impairing the FSLIC's ability to elicit the best possible bids for troubled thrifts at the earliest possible time. Removing the current restrictions would enable the FSLIC to develop more creative solutions of benefit to the FSLIC. It also would permit qualified bidders with much needed capital, both in-state and out-of-state, to participate more actively with better expectations of success at an earlier stage in the FSLIC's dealings with a failing thrift.

FSLIC Conservatorship and Receivership Powers

I also strongly endorse reinstating section 122 of the Garn-St Germain Act. This section gives the Board exclusive direct authority and jurisdiction, notwithstanding state law, to appoint the FSLIC as conservator or receiver for state-chartered insured institutions. This is the same authority granted the Board for Federal associations. At the same time, in deference to the dual banking system, section 122 provides that if the responsible state authority does not concur in the FSLIC's appointment, the Board must wait 90 days and only proceed after a unanimous vote. Since this provision's adoption in 1982, the Board has made 75 appointments of the FSLIC under this authority as receiver (61 appointments) or conservator (14 appointments).

The Board and the FSLIC continue to have extremely good relations with state authorities, and the FSLIC will continue to work closely and cooperatively with state officials to resolve all problems involving failed thrifts, even if not required to do so by statute. But I believe the added flexibility afforded by section 122 is vital to provide appropriate safeguards for the enormous federal financial stake in resolving the problems of troubled thrifts. I urge you to reinstate the Board's authority in this area so that we can take prompt Federal action to deal with institutions that may impose tremendous burdens on the FSLIC's resources.

Conversions

Another important emergency provision is section 121 of the Garn-St Germain Act, which added section 5(p) to the Home Owners' Loan Act of 1933. This section empowers the Board to authorize any mutual institution (state or federal) to convert to federal stock form, notwithstanding any other state or federal law. This provision also serves as a basis for the Board's modified conversion regulations, which aid a single financially strong individual or corporation to make substantial stock purchases in low net worth institutions. This beneficially expands the bidder pool for weakened institutions because individuals or organizations seeking to infuse capital into such institutions frequently seek to gain control of the institution.

In summary, I strongly urge reenactment of the emergency provisions of Title I of the Garn-St Germain Act. The loss of these powers can only serve to further imperil the FSLIC's efforts to meets its insurance obligations by the most cost-effective means available.

IV. DEPOSIT AVAILABILITY

The Committee has also requested my views on legislative proposals designed to protect the consumer by modifying financial institution practices on the availability of funds on deposit. I would like to focus my comments on the need for uniform rules and disclosure policies and raise some considerations that Congress should take into account in balancing the costs and benefits associated with such requirements.

The "Fair Deposit Availability Act," as passed by the Senate last session, as Title 2 of S. 2747, provides a uniform federal statutory framework to address concerns raised by check hold policies. That legislation contained the following major substantive provisions affecting "check-hold" practices: (1) disclosure requirements, (2) interest payment requirements, (3) a mandate to the Federal Reserve Board to promulgate federal regulations to improve and expedite the check clearing system, (4) treatment of U.S. Treasury checks, and (5) administrative enforcement and civil liability provisions. I will briefly discuss each.

I strongly endorse this legislation. I believe that consumers must be assured that institutions will not place unnecessary "holds" on funds deposited into customer accounts in the forms of checks and check-like instruments. Similarly, full disclosure of institutions' funds availability policies is vital to ensure fairness and informed "comparison shopping" by consumers for the services that best meet their needs. As you are aware, on March 22, 1984, the Bank Board, in conjunction with the other federal financial institution supervisors, issued a policy statement affirming both of these goals.

I believe Federal regulation will substantially aid customer access to their deposited funds as quickly as possible. As the funds transfer system becomes increasingly automated, the potential exists to achieve this goal while providing institutions with adequate safeguards against returned checks. In that regard, I think the view of banks and thrifts will be helpful to the

Committee in avoiding undue costs or operating problems for institutions. I look forward to working with Congress and the other agencies to help develop and implement a system that will enable depositors to have such access.

V. EXPANSION OF BANK HOLDING COMPANY SECURITIES POWERS

You have also asked for my views on the proposal to grant bank holding companies new powers to deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and mutual funds. I have no objection to such expansion of bank holding companies' authority.

STATEMENT BY

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

Mr. Chairman, Members of the Committee:

We appreciate having this opportunity to speak with you about these issues important to the banking and thrift industries.

We have provided below our thoughts on each issue you have raised. At the outset, we also encourage a broad review of the financial services industry with the intent of achieving a proper competitive and supervisory balance. We hope such a review can take place in the near future.

FSLIC Recapitalization

The FDIC supports the proposal of the Administration and the Bank Board to recapitalize the FSLIC. Quick approval by Congress is important to maintain confidence in our financial system and reduce the ultimate cost of handling failing savings and loan associations.

Because of limited resources, the FSLIC has not been able to resolve problems in a significant number of failing savings and loan associations. This condition cannot be permitted to continue without seriously impairing confidence in the financial system. Moreover, delaying the closing of insolvent institutions increases the ultimate cost of failures. In some instances, imprudent management may succumb to the temptation to take excessive risks, to roll the dice in the hope that insolvency can be overcome. In addition, continuing operating losses add to the extent of insolvency and thus increase the ultimate cost of disposing of such institutions.

Failing savings and loans consistently pay above market rates for their funding. This not only adds to their cost, it puts pressure on the system as a whole, raising funding costs and cutting into earnings for competing, solvent institutions. For these reasons, we believe that delay is imprudent, destabilizing and costly. The FSLIC recapitalization plan should be enacted quickly; it should, in our view, be given the highest priority.

Regulators' Bill

The FDIC continues to request the enactment of this proposal. Emergency interstate acquisition powers will enhance our ability to handle failed and failing banks with a minimum of disruption to local economies and a minimum cost to the insurance fund.

Actions with respect to interstate purchases taken by a number of states have reduced the urgency of this legislation. Currently, 37 states have enacted legislation providing for some form of regional or national full-service interstate banking. (The current status of interstate-banking activity is discussed in Appendix A.) Of particular significance, several states that have had high failure rates are among

those that have adopted some form of interstate banking. We applaud these states' efforts. Unfortunately, several states with high bank failure rates have not changed their laws. (Refer to Appendix B.)

In 1986, 138 insured banks failed and another seven were given financial assistance to prevent failure. We expect a sizeable increase in the number of failures in 1987. Along with increased failures, the number of problem banks has also increased significantly. From just 200 banks in the spring of 1981, the number of problem banks has increased each year. The number reached 1,140 at the start of 1986 and climbed to 1,484 by year-end -- a growth rate of almost one bank a day. Weaknesses are likely to persist through next year or longer in energy, agriculture, and real estate. Parts of the banking system will continue to be hurt by these strains. Competitive forces also have made it more difficult for banks to improve profitability. Such problems are exacerbated by geographic restrictions which limit diversification possibilities for banks and can lead to excessive exposures to one source of risk.

Whenever possible, the FDIC attempts to arrange a purchase and assumption transaction (known as a P&A) to handle failed banks. In such transactions another institution purchases some of the failed bank's assets and assumes deposits and other liabilities. An acceptable P&A is less expensive to the FDIC. It is less disruptive to depositors because deposit arrangements of the failed bank are generally honored by the acquiring bank. Also, many assets of the failed bank are retained by the acquiring bank, minimizing disruption to the borrowers and reducing the FDIC's involvement in servicing and liquidating failed bank assets. Finally, a P&A is responsive to the question of fairness since we protect all depositors, thus treating all failed banks in a manner similar to that required in handling very large institutions.

The increased numbers of bank failures, the geographic concentration of banking problems, and the relatively large size of some troubled banks are making it increasingly difficult to find purchasers for all failed banks. As recently as 1984, the FDIC was able to find buyers for P&As in 80 percent of bank failures. This percentage has declined to only 68 percent in 1986. Not only has the percentage of bank failures handled through P&As declined but the price paid by the acquiring banks in these transactions also has dropped. The average premium received in a P&A transaction has declined from 3.67 percent of deposits in 1984 to 0.87 percent of deposits in 1986. These trends have significant adverse implications for the FDIC insurance fund. Total purchase premiums received on P&As in 1986 were roughly $22 million less than in 1984 although the volume of failed bank deposits was more than double. The relative drop in premiums paid for failed banks translates into significant additional costs to the insurance fund.

In order to enhance the FDIC's ability to handle the growing number of failing banks, we continue to seek authority that would:

- Allow acquisition by an out-of-state institution of failed and failing banks;

TABLE A-1

Bank Interstate Expansion Opportunities

(January 15, 1987)

	Nationwide		Regional[3]		Emer. Takeover Provisions		Non-bank Banks[4]	Indus. Banks	Limited Service Banks
	Unltd	Reciprocal	Unltd	Reciprocal	National	Regional			
AL				7/87[1]			X		
AK	X						X		
AZ	X						X		
AR							-	X	
CA		1/91[2]		7/87[1]			X	X	
CO							-	X	
CT				X			-	X	
DE							X		X
DC				X			X		
FL				X			-	X	
GA				X			-		
HI							-	X	
ID				X		X	X		
IL				X			X		
IN				X		X	X	X	
IA							X	X	
KS							-	X	
KY		X			X		-	X	
LA		1/89[2]		7/87[1]			-		
ME	X						X		
MD				X			X		X
MA				X			X		
MI		10/88[2]		X			X		
MN				X	X		X	X	
MS				7/88[1]			-		
MO				X			X	X	
MT							X		
NE							X	X	X
NV	1/89[2]			X			X	X	X
NH							X		
NJ		X[5]		X			-		
NM					X		-		
NY		X					X		
NC				X			-	X	
ND							-		
OH		10/88[2]		X	X		X		
OK		7/87[2]			X		-		
OR			X				-		
PA		3/90[2]		X			-		
RI		7/88[2]		X			X	X	
SC				X			X		
SD							X		X
TN				X			-	X	
TX	X						-		
UT	12/87[2]			X	X		-	X	
VT							-		
VA				X			-		X
WA		7/87[1]			X		X	X	
WV		1/88[1]					-	X	X
WI				X			X		
WY							X		

[1] Effective date.

[2] Trigger date for nationwide banking.

[3] Anti-leapfrogging provisions are generally included in the language of regional banking laws. Only one state -- Nevada -- of the 28 with regional banking laws does not have an anti-leapfrogging provision.

[4] These states permit the establishment of non-bank banks.

[5] Nationwide trigger dependent upon 13 states having nationwide reciprocal laws in effect; four of the 13 states must be among the largest 10 states in terms of total deposits.

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- Extend the scope of interstate acquisition authority to include bank holding company systems when the failing bank represents a sizable part of the holding company system; and

- Provide the FDIC with authority to run a failed bank for a limited period of time to facilitate a more orderly disposal of the bank.

Allowing acquisition of a failed bank by an out-of-state bidder greatly expands the number of potential acquirers and enhances the chances of finding a purchaser for a P&A. Increased competition among an increased number of bidders will reduce costs to the FDIC. This is true regardless of the size of the failed bank. The Regulators' Bill required that the failed or failing bank have at least $250 million in assets before interstate bidding would be allowed. Today about 95 percent of problem banks are below that level with significant concentrations in states that do not allow out-of-state entry. This size requirement was intended to provide a transition from then current law. We now recommend that the threshold be eliminated. It should be noted that size limitations are rare among the many states that have enacted interstate legislation. The asset size of a failed bank is only one measure of significance -- and not a particularly good one in terms of assessing the impact on the community served if a P&A cannot be achieved and a payoff must be made. The liquidation of any bank reduces banking services in the community, increases local economic disruption, and increases costs for the FDIC. For these reasons our objective is to avoid payoffs of failed banks whenever possible. We are making progress toward this goal; the average amount of uninsured deposits in failures handled by payoff (including insured deposit transfers to another institution) has declined each of the last three years. (See Table 1.) Still, this is of little comfort to the unsuspecting depositors with uninsured funds in such banks.

Since the Regulators' Bill was first proposed, a number of states have passed laws which allow entry by out-of-state institutions under varying conditions. Such initiatives have materially expanded our options. During the past year, out-of-state institutions were invited to submit bids in 35 failed bank situations, and submitted the best offer in two instances. However, varying rules among states create administrative problems and uncertainty for both the FDIC and interested bidders. In addition, many of the states have incorporated reciprocity restrictions, expansion restrictions or other constraints that limit the attractiveness to many potential out-of-state bidders for failed banks.

The Regulators' Bill also would permit the interstate acquisition of failing banks. We support this because, once a bank has failed, its value to a potential acquirer can be substantially diminished. In such instances the FDIC's options are reduced and potential costs are materially increased. The Bill would also allow the interstate acquisition of an entire holding company when one of its significant bank subsidiaries is failing. This is important because the economic reality is that holding company banks are frequently managed and operated as a consolidated entity and not as independent individual banks. When institutions are operationally and financially intertwined, it is difficult to separate a single failed institution from the rest of its family.

Last year's bill contained provisions that would not permit expansion in the state by the acquiring out-of-state institution until two years after the acquisition of the failing bank(s). The FDIC would prefer that there be no special delay for acquiring banks and that the new banks be given the same rights as their competitors. In acquisitions involving a failing bank, we continue to support a preemption of regional compact provisions that restrict bank expansion outside the compact.

If Congress should decide that the legislation proposed as the Regulators' Bill should not be passed then at least the expired interstate provision of Garn-St Germain should be renewed. This Act provided for interstate acquisitions of failed banks with assets of $500 million or more. That provision significantly increased the FDIC's options in several bank failures. For example, early in 1986 the interstate provision was used in a Florida failure and saved the FDIC a substantial sum.

Even with interstate powers there can be situations where options may still be very limited. We have encountered situations involving both larger and smaller banks, where material uncertainties precluded bidders from making informed and intelligent bids. In these situations, putting together a satisfactory P&A was very difficult or impossible in the short time available.

What is needed in these circumstances is a method to "bridge" the gap between the failed bank and an orderly purchase and assumption transaction -- a fallback position for the FDIC. The FDIC seeks authority to operate a full-service bank on a transition basis for a limited period of time. The objective would be to return the failed bank's assets to the private sector in an orderly manner. Bridge banks are not intended to be used frequently. The FDIC has no desire to be in the banking business. However, in exceptional circumstances, this power could be an invaluable aid in minimizing economic disruption and reducing FDIC costs, particularly in handling major failures in the banking system.

As a part of the Regulators' Bill, the FDIC continues to seek Congressional confirmation that it and the Office of the Comptroller of the Currency are exempt from budget apportionment by OMB. We strongly urge Congress to include language to that effect in the Regulators' Bill. Particularly during these troublesome times, we believe the FDIC must maintain the flexibility to cope speedily and innovatively with the problems in the banking industry. OMB is attempting, for the first time, to apply 36 year-old legislation to control the FDIC's funds. There is no justification for suddenly trying to do this now!

On a related issue I would like to strongly recommend passage of S. 288 recently introduced by Senator Riegle. This bill recognizes the importance of attracting and maintaining high caliber examiners during these increasingly challenging times. Comparable legislation was passed by a large margin (340 to 49) in the House last year and merits a full hearing and passage by the Senate this year.

Nonbank Banks

Nonbank banks are the outgrowth of a loophole in the Bank Holding Company Act, in which Congress narrowed the definition of "bank" to those institutions that both accept demand deposits and engage in commercial lending. By offering only one of these services, the nonbank bank can carry out most of a bank's principal activities without coming under the restrictions and regulations of the Bank Holding Company Act. Such an institution is eligible for federal deposit insurance.

This is an attractive option for nonbanking firms and for bank holding companies alike, as they can access new sources of funds and new lending markets that, within the current regulatory framework, are not available to banks. Through the use of the nonbank bank, nonbanking firms can enter the business of banking without becoming a bank holding company and therefore need not divest themselves of business activities not "closely related to banking." In addition, bank holding companies can avoid the Douglas Amendment to the Bank Holding Company Act and overcome geographic restrictions against interstate banking.

Nonbank banks became increasingly popular in the early 1980s, with applications for about 400 charters submitted to the Comptroller of the Currency. Nonbank banks have become increasingly controversial as well. There is concern that nonbank banks pose a threat to the safety and soundness of the banking system. Also, many bankers argue that nonbank banks create inequities in the financial system because they enjoy an unfair competitive advantage over "real" banks.

With regard to safety and soundness concerns, we do not believe nonbank banks, if subjected to prudential regulation and supervision, should pose any major risks to the system. Our experience is consistent with this observation. The FDIC began insuring nonbank banks as early as 1969. None of these institutions has failed and less than two percent are on our problem bank list. This compares to a problem bank ratio of about 10 percent for commercial banks.

Nonbanking activities of bank affiliates can bring the benefits of financial product diversification to the system. Increased diversification and earning power will reduce risk and increase earnings in banking organizations, thereby strengthening the overall banking system. Such activities also can lead to increased competition in securities, insurance and other markets, reducing costs to consumers.

Currently nonbank banks do not control a significant proportion of banking resources. Available data indicate that they play a comparatively small role in the system. The total deposits held by FDIC-insured nonbank banks, using the broadest definition of nonbank banks, are only about $12 billion, about 0.6 percent of total domestic deposits. Thus, at current levels nonbank banks are not a serious threat.

Nonetheless, we believe that the present statutory system is highly inequitable and detrimental. Allowed to grow, nonbank banks can weaken the real banks by competing in an unfair contest in the market place. We believe that, within the financial system, institutions must be treated fairly. We need a set of ground rules that are consistent and equitable, not only because this is right but because it will strengthen the system. The rules should be spelled out clearly, and they should be enforced. The question facing us, then, is how a fair and equitable system can best be achieved.

Closing the nonbank bank loophole may arguably reduce or eliminate some of the problems and inequities associated with nonbank banks. However, if that is the only reform adopted, additional problems will likely arise. For example, a thrift loophole would still exist, which will insure that inequities associated with nonbank banks continue to exist through unitary-thrift holding companies. Indeed, one such institution, owned by a large automobile manufacturer, has deposits of approximately $10 billion, a figure that is not substantially less than the deposits of all FDIC-insured nonbank banks.

Grandfathering of existing nonbank banks also leaves inequities in place. As is currently the case, individual ownership of any combination of bank, nonbank bank or other business would remain possible. Simply closing the nonbank bank loophole will not provide us with a financial system that is both fair and consistent.

With regard to the so-called "South Dakota loophole," we find this statute objectionable and paradoxical in that it authorizes banks chartered in South Dakota to underwrite insurance in any state but South Dakota. It should be noted, however, that no banks in South Dakota are currently underwriting insurance while several major insurance companies own FDIC-insured depository institutions. Once again, the solution to existing inequities may lie in the direction of expanding ownership relations rather than trying to stamp out loopholes.

If we truly desire to level the playing field, a broader approach is needed. We must examine more than just the nonbank bank or South Dakota loophole in isolation. We must also address the broader questions of bank ownership and bank powers, in conjunction with a redefinition of the term "bank." We believe that all institutions enjoying the privilege of federal deposit insurance should operate under the same regulatory rules and ownership restrictions. If restrictions are appropriate for one, they are appropriate for all. Only when those who elect to have deposit insurance also elect to operate under common rules and regulations can the system operate fairly and efficiently.

New Powers for Banks

This brings us to the subject of additional powers for banks. Currently a limited set of new bank powers is under discussion. These powers include the authorization to underwrite and deal in mortgage-backed securities, commercial paper and municipal revenue bonds and to sponsor mutual funds. If granted, these new powers could improve the system and allow banks to remain, or once again become, viable competitors in the financial marketplace.

These activities are not unlike many of the activities pursued by banks today. Indeed, they appear to be natural extensions of banking skills and expertise, and probably would expose banks to less risk than direct credit transactions.

Underwriting and dealing in mortgage-backed securities is a natural extension of writing home mortgage loans. The ability to package and sell such loans would provide banks with greater flexibility. The power to underwrite and deal in municipal revenue bonds is increasingly important as these instruments (which were virtually nonexistent when Glass-Steagall was written) continue to play a larger role in the municipal bond market. At the time Glass-Steagall was adopted, this market was dominated by general obligation bonds, in which banks were given permission to deal. Banks are being increasingly and unfairly forced from municipal underwriting. Morever, as more creditworthy firms choose to raise funds by issuing their own commercial paper, banks must increasingly look for other, perhaps riskier, loan customers. We believe these new powers pose no significant additional risk, and can be housed safely within banks.

In addition to these powers, we believe that banks should be permitted to sponsor mutual funds. The mutual fund market has seen considerable expansion in recent years -- expansion from which banks have been excluded. Allowing banks to offer and manage mutual funds will increase their ability to recapture business lost to nonbanking competitors in recent years. This activity, too, is a natural fit for banks. Their experience with common trust funds and commingled investment funds has provided them with the necessary skills. And, as in the case of such trust activities, we see no evidence of excessive risk or loss associated with the sponsoring of mutual funds.

We believe mutual funds could be housed within the bank, provided restrictions similar to those currently placed on trust activities are required. Banks should be required to provide adequate disclosure that these funds would not be federally insured and that customers would be exposed to risk.

In the interests of competitive equity and safety and soundness, it is essential that banks be accorded new powers. It also is essential that adequate supervision and safeguards be integrated into the system. We feel that the list of new powers under discussion today does not represent a comprehensive list of powers that could safely be granted to banks.

Activities not permitted for banking organizations in the United States in securities and other areas have been performed by affiliates of U.S. banks in the United Kingdom and elsewhere in the world for some time. These activities have contributed to profitability and they generally have not posed safety and soundness problems.

On the whole, we feel that banks should be permitted to offer financial and financially related services within the bank so long as

such activities can be properly supervised, and do not expose the bank and the deposit insurer to inordinate risk. Additional activities that may involve greater risk should be permitted for subsidiaries or affiliates of banks and bank holding companies with adequate insulation of the bank provided by law. As long as regulators can take the actions necessary to insulate the banks from the operations of a subsidiary or of the bank's owners, we feel there is room for greater expansion of the permissible activities of bank owners and affiliates. A thorough study of this matter should explore the possibility that any corporation be permitted to own banks.

Check Holding Practices

The FDIC supports efforts to ensure that bank deposits be made available within reasonable timeframes. We already have taken action to achieve this objective. In early 1984, the FDIC, along with other federal regulators, issued a joint policy statement encouraging depository institutions to review their current policies, to reduce delays in funds availability where feasible, and to provide adequate disclosure of their policies. We also adopted a program for reviewing and monitoring response to the joint policy statement.

We believe these efforts have proven productive and note that funds availability account for under two percent of all consumer complaints processed by the FDIC. Surveys conducted by the FDIC indicate most banks give immediate credit to established customers, with delayed availability applied only on an exceptional basis. Also, a number of states have passed or are considering laws that would require disclosure of availability policies and/or establish fixed availability schedules (See Table 2.)

The FDIC believes considerable progress has been made to address concerns about funds availability and that abuses are the exception rather than the rule. Nevertheless, we support federal legislation in order to establish a national policy and provide a means for dealing with abusive practices. Federal legislation would also reduce inconsistency caused by varying state laws.

The Fair Deposit Availability Act (S. 1841) proposed in the last Congress would have required depository institutions to provide written disclosure to customers of its funds availability policies. We strongly support this goal and believe such disclosures would enable market forces to work more efficiently. We also support the requirement that a depository institution must start computing interest on funds deposited by check or similar instrument to an interest-bearing deposit as soon as it receives provisional credit for the deposit. We believe this would be fair and present negligible credit risk to the depository institution.

The proposed law also would have required that deposits of U. S. Treasury checks by established customers be made available for withdrawal as soon as the depositing institution received provisional credit for such checks. This approach seems fair and reasonable. It would be particularly beneficial for persons who must rely upon government checks as their main source of income. Generally, delayed availability complaints about government checks involve senior citizens, where the financial hardship is likely to be the greatest.

We do not agree with all provisions of S. 1841. The proposal would have required the Federal Reserve Board to impose a precise funds availability schedule on deposits. Given the diversities in this country with respect to geographic location, transportation facilities, use of technology, and structure of financial institutions, imposing a single uniform availability schedule could prove inequitable and burdensome. Moreover, the cost of imposing a quick availability requirement on all deposits would ultimately be borne by all depositors, regardless of the need for it.

The proposal also would have established an "Expedited Availability Council" to consult with the Federal Reserve Board on funds availability matters. We see no need for creating another regulatory council or assigning the Federal Reserve an oversight role. A more practical and efficient approach would be to give the responsibility directly to the respective regulatory agency.

Conclusion

The topics before this Committee are of the utmost importance to the stability and well-being of the Nation's financial system. I urge you to give the highest priority to recapitalizing the FSLIC, providing more flexibility to the FDIC to deal with current and future problems within the industry and increasing investment options available to commercial banks.

Although these are important issues that need to be dealt with expeditiously, the long-term viability of the Nation's banking and financial system is dependent upon a critical and thorough analysis of the current laws and regulations that govern banks and other financial institutions. It is clear that current rules were developed in a much different economic and legal environment and are no longer appropriate. The FDIC stands ready to assist the Committee, in any way possible, in developing a sensible and fair set of standards that will guide the future development of the system.

Appendix A

CURRENT STATUS OF INTERSTATE BANKING

Currently, 37 states have enacted legislation providing for regional or national full-service interstate banking. (See Table A-1) Much of the expansion in geographic authority has occurred during 1986 as nine states adopted reciprocal legislation, while West Virginia, Oklahoma and Texas provided for nationwide banking. Texas is the ninth state to have adopted nationwide banking legislation. Twenty-eight states have passed regional banking legislation; nine of these regional laws have triggers authorizing nationwide banking by a certain date. Almost all of this expansion has taken place in the last four years with the exception of Maine's national legislation adopted in the mid-70s.

State actions represent a recognition of the new competitive environment challenging banks and the consequent need for banks to diversify and expand geographically. De facto interstate banking already exists to a large extent as banking organizations have used nonbank banks, nonbank subsidiaries, loan production offices, Edge Act subsidiaries, limited-service banks and industrial banks to establish an interstate presence. Another avenue of expansion for commercial banks had been the emergency acquisition provisions of the Garn-St Germain legislation; however, the provisions authorizing interstate acquisitions expired during 1986.

Continuing economic problems in the agricultural and energy sectors have also prompted several states to reduce interstate and intrastate barriers to limit the negative effects of bank failures. Oklahoma, New Mexico and Utah adopted emergency takeover provisions during 1986, bringing to eight the number of states permitting nationwide takeovers in emergency situations.

The Texas legislature adopted one of the nation's most liberal interstate banking laws. Banks from any state are permitted to acquire Texas banks as of January 1, 1987.

In California, recent legislation authorizes regional reciprocal banking with eleven western states: Alaska, Arizona, Colorado, Hawaii, Idaho, Nevada, New Mexico, Oregon, Texas, Utah and Washington. The California law triggers to nationwide reciprocal banking on January 1, 1991.

Several states are expected to consider interstate banking bills when the state legislatures reconvene in 1987. In Colorado, the proposed legislation is anticipated to take the form of a regional reciprocal law with the seven contiguous states. During 1986, the Vermont House and Senate passed different versions of regional banking legislation; however, a conference committee was unable to reconcile the bills. The regional legislation will be reconsidered in 1987. Iowa will also reconsider emergency takeover legislation, which was narrowly defeated during the 1986 session.

Appendix B

ENTRY BY OUT-OF-STATE BANKING ORGANIZATIONS INTO STATES WITH HIGH BANK FAILURE RATES

Eleven states have accounted for about 80% of bank failures during the last two years. Of the eleven states, five -- Colorado, Iowa, Kansas, Nebraska and Wyoming -- have not authorized entry by out-of-state banking organizations through interstate banking legislation or emergency interstate takeover provisions. Kansas, Nebraska and Wyoming do waive intrastate restrictions in failing bank situations.

The remaining six states all acted in 1986 to authorize entry by out-of-state banking organizations. Texas allows entry on a nationwide nonreciprocal basis. Oklahoma and Minnesota permit entry by out-of-state organizations in failing bank situations if in-state acquirers are unavailable. California, Louisiana, Minnesota and Missouri adopted regional reciprocal banking legislation. Triggers to nationwide banking are included in the California and Louisiana regional banking laws and Oklahoma's emergency interstate takeover legislation.

Texas - 38 failures (26 in 1986, 12 in 1985). In September 1986, the governor signed legislation permitting the acquisition of Texas banks by banking organizations on a nationwide basis beginning January 1, 1987. Reciprocity is not required.

Oklahoma - 29 failures (16 in 1986, 13 in 1985). In May 1986, Oklahoma enacted legislation permitting out-of-state banks or bank holding companies to acquire failing Oklahoma banks if no in-state buyers are available. As part of the legislation, Oklahoma would permit nationwide interstate banking on a reciprocal basis beginning July 1, 1987.

Kansas - 27 failures (14 in 1986, 13 in 1985). Kansas has not authorized entry by out-of-state banking organizations through interstate banking legislation or emergency interstate takeover provisions. In March 1986, the governor signed legislation permitting emergency intrastate acquisitions of failing and failed banks in small towns.

Iowa - 21 failures (10 in 1986, 11 in 1985). Iowa has not authorized entry by out-of-state banking organizations through interstate banking legislation or emergency interstate takeover provisions. A 1986 legislative proposal, which would have permitted bank holding companies in eight contiguous states to acquire failing Iowa banks if no in-state buyer could be found, failed to gain the approval of the legislature.

Nebraska - 19 failures (6 in 1986, 13 in 1985). Nebraska has not authorized entry by out-of-state banking organizations through interstate banking legislation or emergency interstate takeover provisions. A 1985 law waives percentage-of-asset limitations on multi-bank holding company acquisitions in failing bank situations.

Missouri - 18 failures (9 in 1986, 9 in 1985). In April 1986, the governor signed legislation authorizing regional reciprocal banking with Arkansas, Illinois, Iowa, Kansas, Kentucky, Nebraska, Oklahoma and Tennessee effective August 13, 1986.

California - 15 failures (8 in 1986, 7 in 1985). In September 1986, the governor signed an interstate reciprocal banking law between institutions in California and 11 Western states beginning July 1, 1987. Nationwide banking on a reciprocal basis will begin January 1, 1991.

Colorado - 13 failures (7 in 1986, 6 in 1985). Colorado has not authorized entry by out-of-state banking organizations through interstate banking legislation or emergency interstate takeover provisions. During 1986, the Colorado legislature failed to pass national and regional interstate banking legislation; these bills died in committee. In addition, a bill authorizing emergency interstate acquisitions failed to secure passage.

Wyoming - 12 failures (7 in 1986, 5 in 1985). Wyoming has not authorized entry by out-of-state banking organizations through interstate banking legislation or emergency interstate takeover provisions. In early 1986, a law was enacted waiving intrastate branching restrictions to permit the acquisition of a failed bank and its subsequent operation as a branch.

Minnesota - 11 failures (5 in 1986, 6 in 1985). In early 1986, Minnesota enacted legislation authorizing regional reciprocal banking with Iowa, North Dakota, South Dakota and Wisconsin. In addition, the legislation contains a provision allowing failing banks to be sold to out-of-state banking organizations if an in-state purchaser cannot be found.

Louisiana - 8 failures (8 in 1986). In June 1986, the governor signed legislation authorizing regional reciprocal banking between Louisiana and the District of Columbia and 14 Southeastern states beginning July 1, 1987. The legislation contains a nationwide reciprocal trigger effective January 1, 1989.

TABLE 1

BANK FAILURES HANDLED
BY INSURED DEPOSIT PAYOFF
(INCLUDING INSURED DEPOSIT TRANSFERS)

	No.	Total Uninsured Deposits	Average Uninsured	Average Size*
1984	16	$25.1MM	$1.6MM	$42.5MM
1985	29	$29.9MM	$1.0MM	19.1MM
1986	40	$22.8MM	$0.6MM	31.2MM

*Deposits

TABLE 2

STATES REQUIRING FUNDS AVAILABILITY PROVISIONS

	Requirements	
	Time Limitations	Disclosure of Policy
California	x	x
Connecticut	x	x
Delaware		x
Florida	x	x
Maryland		x
Massachusetts	x	x
Montana		x
New Jersey		x
New York	x	
Oregon		x
Rhode Island	x	x
Missouri	x	x
Illinois	x	x

The **CHAIRMAN**. Well, thank you very much, Mr. Seidman, and congratulations on your spirited wife. Her heart is in the right place.

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Mr. Clarke, the Office of the Comptroller which you head was created by an act of Congress I think in 1863. As the Comptroller, you are responsible, as you know, for the execution of laws related to the national banks passed by Congress. You are not free to follow your own predilections as to what you wish the banking laws were. I'm sure you agree with that.

How do you account then for the article that appeared in the December 29 Wall Street Journal—I spoke about it on the floor of the Senate recently—that said your office had created a special unit to concoct new organizational structures for banks. The purpose of the organization is to provide new dodges around the old slate of banking laws.

Now first I want to know if that's true, and if so, how is that consistent with your obligation to enforce our current banking laws?

Mr. **CLARKE**. Senator, I think that one has to be careful about the way things are sometimes characterized in the press. I don't think that that is an accurate statement.

As you know, there are numerous proposals filed with our office for various creative, innovative banking products, some of which we approve and some of which we don't. As a result of having this volume of proposals filed in our office, we do have people on our legal staff who have to stay on top of new developments and the court decisions that are rapidly coming down, but I don't——

The **CHAIRMAN**. Have you created a unit for the purpose of enabling the banks to find ways around the laws? They are well-equipped and they have shown their ability to do that all by themselves without any help from the taxpayer.

Mr. **CLARKE**. No, sir. We do not have special groups of shock troops that are out there trying to figure out ways around the laws.

The **CHAIRMAN**. I hope you will make sure that that continues to be the case.

Mr. Gray, the U.S. League plan is said to not provide sufficient funds for adequate case resolution. The Treasury plan would provide about $21 billion within a 5-year timeframe. The U.S. League plan would provide about $14 billion I understand in the same time period.

Is the U.S. League's plan proposed funding volume sufficient to meet FSLIC's needs?

Mr. **GRAY**. No, it is not, absolutely not.

The **CHAIRMAN**. Well, I should be satisfied with a short answer, but would you give me about three sentences?

Mr. **GRAY**. I'll tell you the reason. As I indicated before, the losses that we can see, that is to say the ones that we know about amount to roughly $19.5 billion. We think the borderline cases have a pretty good chance of adding roughly $4 billion to that $19.5 billion. This brings the anticipated cost of FSLIC case resolution up to

$23.5 billion. So it's well above what the U.S. League plan talks about.

The CHAIRMAN. Thank you, sir.

Mr. Seidman, Chairman Gray states on page 17 of his testimony:

> It is important to the health of the FSLIC to enact legislation to close the nonbank bank loophole, as the presence of the loophole makes it more difficult and expensive to find bidders willing to negotiate seriously to acquire a failed thrift to achieve interstate operating rights.

That means, he says, "that FSLIC must further deplete its own resources to resolve troubled cases."

Do you agree with that view?

Mr. SEIDMAN. I do not.

The CHAIRMAN. Why not?

Mr. SEIDMAN. That's an expedient view which simply builds into the financial system more exceptions, others who can compete unfairly, and I think it's unfair to the banks.

The CHAIRMAN. That sounds as if you do agree with Mr. Gray.

Mr. SEIDMAN. Well, I do agree, but I don't want to have him say there will be no nonbank banks so that I can create exceptions with my institutions.

The CHAIRMAN. Do you want to respond to that, Mr. Gray?

Mr. GRAY. I'm not sure I understand that, but——

The CHAIRMAN. Well, I thought maybe you would enable me to understand it by responding.

Mr. GRAY. Well, I'm not sure exactly what he means.

Mr. SEIDMAN. Well, your institutions have certain special powers which make them more valuable which are somewhat equated to nonbank bank powers.

The CHAIRMAN. The point that Mr. Gray makes is that failing to close the nonbank bank loophole would make it more expensive for FSLIC to do its job.

Mr. SEIDMAN. Oh, I agree with that.

The CHAIRMAN. You agree with that?

Mr. SEIDMAN. I agree with that. If it's just a judgment of whether it makes it more expensive or not, yes, I agree with that.

The CHAIRMAN. All right.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

First of all, despite the fact that our legislature in Texas in a very enlightened move has made the regulators' bill irrelevant in my State and it was quite an achievement in a State where prior to the turn of the century, at least in the minds of most in Texas, the distinction between banking and counterfeiting was a subtle one. [Laughter.]

I want to pledge to you that I am going to continue to vigorously support the regulators' bill because I think we need it and I think the thresholds ought to be lowered.

I am also going to support FSLIC recapitalization so I would like to take my time on trying to do a little better job on posing a question to two of you than I did to Chairman Volcker.

I am concerned about differential treatment of bank holdings based on the origin of those holdings. I am not in favor of regulating bank assets and classifying them based on market value when they are security, so that if you were doing that any time interest rates changed the market value would change, deviating from the face. That's not what I am concerned about.

I am concerned about a situation where clearly, in my opinion, if you had domestic banks on domestic paper lending money to pay interest, you would hardly call that paper self-serving.

DIFFERENCE IN VALUING THIRD WORLD PUBLIC AND PRIVATE DEBT

And I would like to begin by asking a simple question. Do you believe that there is a difference in the practice in terms of valuing Third World public and private debt on bank balance sheets as compared to valuing domestic debt on bank balance sheets?

Let me begin with you, Mr. Clarke.

Mr. **Clarke**. Senator, I would say that there is a difference in the sense that you are dealing with different kinds of credits. I get asked the very same question that I'm sure you get asked all the time—how do you justify the difference?

It seems to me, as Chairman Volcker said, that you're talking about a difference in type of debt. You're talking about debt that is either guaranteed by or is the direct obligation of a country versus debt that is the direct obligation of an individual or corporation. If there is an individual debt in Mexico, to use Mexico as an example, or a corporate debt in Mexico, that debt is treated for regulatory purposes the same way as domestic debt.

Senator **Gramm**. Well, let me ask you a question. Do you have more future in the value of real estate in Houston, TX, which is depressed today—do you have more confidence in that or in the guarantees of the Mexican Government?

Mr. **Clarke**. I'm probably not the best person to ask that question. As part of the tax base of Houston, I might have a little conflict of interest. But I don't think that's the proper focus, Senator.

Property values in Houston may well come back. I hope they will. But you are looking at a country and at the capacity of that country to service its debt long term, just as people look at the capacity of the United States to service its country debt long term.

As Chairman Volcker said, there is a mechanism in place in which all three of the Federal bank regulators participate where we evaluate that country debt, and when it is repudiated or when it has not been performing for some period of time, it is classified, the same as private debt. And reserves are required to be held against it.

There is a parallel, but I think it's important to focus on the difference in the type of debt that you're talking about. There is a difference between country and private debt, just like there's a difference between U.S. Treasury obligations and obligations of private citizens in the United States.

Senator **Gramm**. Let me pose the same question in abbreviated form to Mr. Seidman. Do you believe that there is a differentiation in treatment between public debt held on balance sheets of financial institutions—I mean private debt in the United States versus either private or public debt with public guarantees in the Third World and does that concern you?

Mr. **Seidman**. Well, I would first subscribe to everything the Comptroller has said. There is a difference between a debt abroad and a debt in the United States and the way you can collect it. You can't foreclose the Government of Mexico. You have to rely from the beginning of that loan on the capacity of that country to make good on the obligation. So it is of a different nature than a private obligation in the United States.

Given that, I would not be at all unhappy if our banks were reserving larger amounts against some of the obligations they have abroad.

Senator GRAMM. Well, let me conclude, Mr. Chairman, since my time is up, by saying I haven't closed my mind on this, but I believe something has to be done to set out a procedure to move toward a more realistic practice because it's not just the capacity of a government to pay; it's the willingness of that government to pay and I think in many cases we are approaching that point and we are creating tremendous instability by carrying on the current practice.

I'm not saying that I've found the way to change it, but I think it ought to be found and found in the first year of this Congress and that we ought to act on it.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I want to express the appreciation of the committee to Mrs. Seidman for keeping the economy going.

There are a couple of things that I would like to get into here. First, Chairman Seidman, I appreciate your endorsing the legislation that I introduced which we call the Depository Institutions Examination Improvement Act, which is designed not only to improve the quality of the examinations but to exempt the bank regulatory agencies from the sequestration requirements of Gramm-Rudman, and these apportionment requirements of the Anti-Deficiency Act.

I assume that, Chairman Gray and Comptroller Clarke, you would support that as well, or are you ready to take a position on that piece of legislation?

Mr. GRAY. Yes, I would and have and do.

Senator RIEGLE. Thank you.

Mr. CLARKE. And I agree entirely.

SPECIAL PROBLEM BANK FAILURES

Senator RIEGLE. Thank you. Now let me ask you this, Chairman Seidman. You say there's going to be a sizable increase in bank failures and we see that coming and I know there are a lot of factors, but sort of in the kind of brevity you used in your summary opening statement, why are we getting this increase in bank failures over and beyond the pile-up of sectoral problems in the agricultural areas or the oil and gas regions of the country where we've got special sectoral problems and therefore regional problems? Those are self-evident.

Apart from that, why are we seeing this sizable increase in bank failures or is it principally and overwhelmingly just due to those special problems?

Mr. SEIDMAN. It continues to be due to those special problems. If you look at bank failures, 90 percent of them are west of the Mississippi.

Senator RIEGLE. And then would it be fair to say that the remainder, outside of those sectoral problem areas, are due to either mismanagement or some other particular problems of a given institution that just didn't do its job properly?

Mr. SEIDMAN. That would be true in practically every case, Senator.

Senator RIEGLE. Now if that is so, can I then make the inference that if a bank today using its traditional and existing operating authorities runs itself properly and intelligently and keeps its overhead down to reasonable levels and is a well-run, efficient business entity, that it should be able to make money and it should be able to survive? Is that a fair judgment?

Mr. SEIDMAN. That's certainly true in the great majority of banks, yes.

Senator RIEGLE. The reason I wonder is that we're getting into the discussion of how banks need to change and the degree to which banks need to broaden out and diversify their services and move into other lines of business and become something that is larger and different than what we have traditionally thought banks to be. We were into that discussion earlier with Chairman Volcker and I have real questions in my mind about that, but I want to hear the argument and I want to understand the degree to which there is this compelling need just for reasons of survival, just for reasons of basic profitability, that maybe banks can't make it in their traditional lines of business even if they are well-run, not in problem areas of the country, and with a reasonable overhead.

But you've just said you think they can. When I think of the fact that banks—and I'm very sensitive to keeping the banking system sound and profitable and to make sure the stability and public confidence is there. I think it's critical to the way our system works.

But having said that, in studying how bank reserves work and the fact that if you take your equity and your deposits you get roughly a 20-for-1 multiplier in terms of your ability to go out and make loans and otherwise deploy your assets, it seems to me that banks, if well-run, in healthy areas of the country ought to be able to be successful and most and many are.

I'm wondering just on that narrow point how much banks in fact need new products, new lines of business, whether or not they invade the traditional definition of commerce, just in order to be viable, functioning profit-making institutions.

BANKS NEED ADDITIONAL POWERS

Mr. SEIDMAN. Well, I can answer that by saying I think they do need additional powers because their traditional position is eroding and it's eroding fast. Automobile loans are moving out, one of their principal businesses. Commercial paper for the big banks are moving out. Bank profits are being squeezed. You asked me could they make money; yes, they can make money, but they are being squeezed.

The stability of the system depends upon their profitability and as they get less profitable they take more chances; they have to go into new businesses; and the old business is gone unless we do something about it.

So I think it's a very serious problem and I think we have to have a level playing field. I think, on the question of Glass-Steagall and whether you are involved with commerce or not, everyone agrees that you have to have a separation between finance and commerce; it's merely a question of what kind. Is it ownership or is it simply rules about how you can operate?

So that's why at the end of my eloquent statement which I didn't read I did state the hope that we would take a broad look at where the financial system ought to be in the 1990's, try to establish those goals, and then move toward them.

One of our problems now is I don't think we have yet an agreement of what those goals are.

Senator RIEGLE. My time is up. I hope there will be a second round because I would like to pursue that just a little bit.

The CHAIRMAN. Why don't you pursue that just a little bit and then we'll finish.

Senator RIEGLE. Thank you, Mr. Chairman.

Well, you didn't have a chance to enumerate that here now and I also want to give Mr. Clarke a chance to comment particularly as it relates to banks as apart from S&L's for the moment. In terms of the need to have new product lines and expansion of definitions of bank functions in order to be able to survive in this new world of financial services and make money and to be viable, it seems to me that the examples that you used, Chairman Seidman, of auto loans and so forth—one way to approach this would be to say, well, what have the banks lost that they used to have? And in a sense, reconstitute or bring back those functions by some means, and there are a variety of devices by which that can be done to help them regain the footholds in markets that they previously had. It seems to me that that might be one avenue to go.

Another avenue to go is to say, no, let's move out into entirely new lines of business. And then you start down through this check list and you go from commercial paper through mortgage-backed revenue bonds to mutual funds to insurance to real estate and then on out into whatever else—if you get a totally integrated conglomerate, you can be in the department store business or presumably anything you want beyond just financial services.

As between those two things, as between trying to find some way to restore what banks have lost in terms of product equivalency on a one-to-one basis versus starting down a road that really moves in successively new lines of business that start to become further and further away from what traditional banking was—I mean, I'd like your thoughts on this. You're one of the people in the country that's in a position to really reflect on this as we think about where we want to be in terms of the banking system in the 1990's or whatever.

So I would like your thoughts and then I would also like the thoughts of Mr. Clarke on that.

Mr. SEIDMAN. I think the basic question is what is going to be done in the bank or at the risk of the bank and what is going to be done in a bank holding company or in some other part of perhaps common ownership which is not at the risk of the bank.

MAINTAINING SAFETY AND SOUNDNESS

So the real question in my mind is what activities should be done within this regulated and somewhat privileged institution that has deposit insurance and so forth and what should be done by perhaps related institutions but not at the risk of the institution that we want to maintain the safety and soundness of.

So our exploration should be what are the appropriate kinds of things that can be done in the bank and are appropriate risks for a regulated institution—because it will always be regulated I believe if it has deposit insurance and a transfer system—what can be done in that institution and what is the harm of someone else over here who may be owned by the same company doing other things.

Senator **Riegle**. What's the point of doing it? I mean, just as an academic question, if you're going to take and separate the two that clearly, why do they have to be the same business or under the same business umbrella? If they are going to be separated that cleanly and that neatly, maybe even having different names or maybe they have the same name on the door, then why do they have to be joined at all?

Mr. **Seidman**. They don't have to be joined at all. The question is, in the kind of world that we're living in, is there any way to keep that from happening and is there any real danger in that? There may be real strength in that. I mean, the strongest thrift around is probably the one owned by Ford if you look at the total resources available to them.

Senator **Riegle**. Mr. Clarke.

Mr. **Clarke**. Senator, I agree with everything Chairman Seidman has said, and I think, as I indicated in my opening statement, the focus has to be on what we are really trying to protect.

You ask why we need to do this. I think that all the studies that have been presented over the last twelve months, even including a study that was done by the Federal Reserve Bank of New York, have indicated that bank profitability is eroding. Now you will also read in the headlines that banks, particularly the money center banks, are announcing good results for 1986, and we're all delighted to see that. But if you analyze what's behind those results and look at where those earnings are coming from, you find that there is less and less that is related to the traditional business of banking and more and more that is related to other activities as banks reach out to expand their areas of operation and their opportunities for profits.

Second, there has been a tremendous erosion by nonbank competitors which are now allowed to engage in activities that banks had formerly provided for customers yet banks are not able to go after their markets—the securities area being a perfect example.

It seems to me that, first of all, you have to decide whether the business of banking is becoming less profitable. I believe it is, and that concerns me because I think that it has a direct safety and soundness effect. If banks can't raise capital and if they are not attractive investment mechanisms, then it's going to be very difficult to ask them to build their capital bases. If they can't earn their capital, it going to be very difficult to ask them to build their capital bases.

If you accept the proposition that you need to do something about the underlying profitability of the industry, then it seems to me the way you approach a solution is not by looking at this product and that service, but instead by asking what it is we're really trying to protect. Then you build a protection system to accomplish that

I think that everybody you've heard this morning, including Chairman Volcker, is really saying the same thing. In his case, it's just a matter of degree—how fast do you move and how far do you go. But all of us recognize that we have a financial system that has traditionally been regulated because there is something there to protect. There is the public confidence in the system. There is the insured deposit taking function. And there is the payments system.

Nobody disagrees that those aspects of the financial system should be protected, and I'm telling you that I think there's a mechanism that will protect them while allowing banks to participate in a broader range of activities that will let them get back into some of the markets and get their customers back and expand into new areas as customers demand different kinds of financial products. I believe that can be done without harming the underlying financial system that we all acknowledge needs to be protected.

Senator RIEGLE. I thank the Chairman for indulging me with another time here because I'd like to see us devote a long discussion on another day to precisely this issue because I think the question of the banking system of the future is really—I mean, this is a critical issue and we're going to decide it either directly or by default and I don't think the issues are completely clear at this point.

Mr. CLARKE. I'll come back and stay as long as you would like.

The CHAIRMAN. I agree wholeheartedly.

The committee will stand in recess until 10 o'clock tomorrow when we hear from the State bank regulators and other officials and representatives of pertinent trade associations.

[Whereupon, at 1:15 p.m., the hearing was recessed, to be reconvened at 10 a.m., Thursday, January 22, 1987.]

STRENGTHENING THE SAFETY AND SOUNDNESS OF THE FINANCIAL SERVICES INDUSTRY

THURSDAY, JANUARY 22, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Cranston, Dodd, Dixon, Sasser, Shelby, Graham, Garn, Heinz, D'Amato, Hecht, and Gramm.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

This is the second of 3 days of hearings on various banking issues that have lain unresolved before the Congress for several years. Some of our witnesses yesterday spoke about the need for the Congress to deal with these issues, including the nonbank bank loophole, and deal with them this year, and the committee fully intends to do exactly that. Chairman Volcker of the Federal Reserve Board told us that the nonbank bank loophole was allowing companies to rip down the wall that has traditionally separated banking and commerce in this country. This, he warned, will permit an increasing concentration of financial and commercial power, which I believe could have deleterious effects on our economy and on our political system. That is why Congress acted time after time in the past to keep commerce and banking separate. But Congress has not responded to the newest challenge from those who would pursue their narrow interests at the expense of a congressionally mandated larger public purpose.

The courts have voiced their own concerns about those challenges but have noted that their job is to enforce laws as Congress has written them and not to expand them so as to plug newly discovered loopholes. The Supreme Court, 1 year ago today in the *Dimension* case, held that the Federal Reserve Board lacked authority to restrict the proliferation of nonbank banks. The decision was based—solely and I repeat, solely—on the narrow definition given to the term "bank" in the Bank Holding Company Act. The court, noting the public policy concerns its decision would raise, said:

> Without doubt there is much to be said for regulating financial institutions that are the functional equivalent of banks. * * * If the Bank Holding Company Act falls short of providing safeguards desirable or necessary to protect the public interest, that is a problem for Congress, and not the Board or the courts, to address.

Likewise, in October 1986, the U.S. Court of Appeals of the Eleventh Circuit reluctantly held in the *U.S. Trust* case that the Federal Reserve Board could not prevent the spread of nonbank banks across State lines. The court acknowledged that its decision "clearly frustrates the congressional purpose expressed in the Douglas amendment" and declared, "It is * * * Congress that must now decide whether it wishes to shepherd the nonbank banks inside the regulatory pale."

Well, the courts have hit the nail on the head. The nonbank bank issue is squarely before us, so let's act on it. Let us not become irrelevant to how the banking policy of this country is made. Let's carry out our responsibility to chart the course of our banking laws.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman. I am sorry that I was unable to be here yesterday but I had a late meeting in Provo and was not able to catch a plane until early yesterday morning.

However, I did have the opportunity to review the testimony and discuss the hearing with my staff and I must say that the reports I received were excellent on what took place in yesterday's testimony.

Reviewing the statements for today and those of yesterday, I'm struck that perhaps the 99th Congress wasn't a waste of time after all. As frustrating as it was that we couldn't even recapitalize the FSLIC, not to mention our inability to address the needs for comprehensive reform in our financial laws, we still made some progress. All of those hearings in 1985 and 1986 have begun to take hold. Based on the reports of yesterday, I believe we have at least elevated the debate and brought the problems more to everyone's attention. It may sound like some rationalization, but I believe it to be true, more and more members of the committee are discussing the structural issues, both domestically and more importantly internationally.

I remember when we held the hearings on the internationalization of the capital markets. I think people are starting to finally wake up to the foreign competition, not just the domestic changes that need to be made. We are moving away from domestic protectionism within the financial securities industry and beginning to debate the kind of financial structure appropriate for today rather than the 1930's. We are beginning to recognize that the dynamics of nonbank competition will increase with or without nonbank banks.

We are starting to question whether the traditional bank profit strategy is showing its age. More and more we are recognizing the inherent unfairness of efforts to broaden bank product offerings while denying flexibility to other financial intermediaries.

We want to explore further the effects on the U.S. economy caused by our domestic financial structure. The importance of global financial competition to U.S. financial firms and its potential effect on world trade is beginning to be understood.

Understanding of the interrelationship of these issues has increased significantly. It's somewhat satisfying to see the major difference in the way we approach some of these issues today as compared to the way we did 2 years ago. I was also pleased to read the joint statement of six banking trade associations announcing a united front to explore new structures for the financial services industry. Continued progress and work of the Mayflower Group is also heartening.

Most don't realize what it was to listen to group after group thinking only of their own narrow interests and not bothering to try to relate to the ever-changing markets. Previously, the only thing that members of the different segments of the financial services industry could agree on was that they were each for "me" and against "them." The problem was no one could agree on who "me" or "them" was.

I don't want to exaggerate our progress. I'm certainly not naive after 12 years on this committee. I know that a great deal more time and effort is necessary if we are going to achieve any common goals, but at least I believe some progress has been made.

Mr. Chairman, I know many believe that it's not possible to act in the financial area without a crisis. Sensing that progress is beginning to be made gives me hope that we can modernize our statutes and our laws in recognition of the technological and competitive realities of today before we have to reach a crisis stage.

However, it is important that we take the steps to recapitalize FSLIC as soon as possible. No one was more frustrated than I was last October when we were not able to enact it. It should have been done then. I don't believe we need to wait or should wait until June, July, or August to get the President's signature on such a bill. The FSLIC simply cannot afford the $6 million a day delay or the liquidity risk that Secretary Gould and Chairman Gray spoke about yesterday. I believe we should act quickly and I believe we can return to the structural issues with new intensity and a willingness to try and act.

I think most are beginning to realize that to regulate effectively we must regulate in reality in what is actually taking place in the marketplace rather than the myth and the dream world that some people seem to live in after all these years.

Throughout the whole process, Mr. Chairman, I look forward to working with you and particularly the new members of the committee that have joined us. Thank you.

[The complete prepared statement follows:]

PREPARED STATEMENT OF SENATOR GARN

DATE:January 22, 1987

Opening Statement

Thank you, Mr. Chairman, I am sorry I was unable to be here yesterday. It was necessary for me to be present at a meeting in Provo, Utah the night before and I was not able to leave for Washington until early yesterday morning.

However I did have an opportunity to review the testimony and discuss the hearing with my staff - and I must say that the reports I received were excellent.

In reviewing the statements for today and those of yesterday, I am struck that perhaps the 99th Congress wasn't a waste of time. As frustrating as it was that we couldn't even recapitalize FSLIC, not to mention our inability to address the need for comprehensive reform in our financial laws, we still made progress. All those hearings in 1985 and 1986 have begun to take hold. Based on the reports of yesterday, we have elevated the debate.

It may sound like rationalization, but I believe it to be true. More and more members of the Committee are discussing the structural issues both domestically and internationally.

* we are moving away from domestic protectionism within the financial services industry
* we are beginning to debate the kind of financial structure appropriate for today.
* we are beginning to recognize the dynamics of nonbank competition that will increase with or without nonbank banks.
* we are starting to question whether the traditional bank profit strategy is showing its age.
* more and more are recognizing the inherent unfairness of efforts to broaden bank product offerings while denying flexibility to other financial intermediaries.
* we want to explore further the effects on the U.S. economy caused by our domestic financial structure.
* the importance of global financial competition to U.S. financial firms and its potential effect on world trade is beginning to be understood.

Our understanding of the interrelationship of these issues has increased significantly. It is somewhat satisfying to see the major differences in the way we approch these same issues only two years later.

I was also pleased to read the joint statement of six banking trade associations announcing a united front to explore new structures for the financial services industry. The continued progress and work of the Mayflower group is also heartening. I know most don't realize what it was to listen to group after group thinking only of their own narrow interest and not bothering to try to relate to the ever-changing markets. Previously the only thing that members of the different segments of the financial services industry could agree on was that they were each for "me" and against "them"-the problem was no one agreed on who "me" or "them" was.

I don't want to exagerate our progress - I am not naive. I know that a lot more discussion in search of common goals is necessary, BUT WE HAVE BEGUN!!

Mr. Chairman, I know many believe that it is not possible to act in the financial area without a crisis but sensing that progress is beginning to be made gives me hope that we can modernize our statutes in recognition of the technological and competitive realities of today before we reach the crisis stage.

However, it is important that we take the steps to recapitalize FSLIC as soon as possible. No one was more frustrated than I when we were unable to enact it last year. It should have been done last October - we must not wait until this June for the President's signature. FSLIC cannot afford the $6 million dollar a day delay or the liquidity risk that Secretary Gould and Chairman Gray spoke of yesterday. We must act quickly. Then I believe we can return to the structural issues with new intensity and a willingness to act. I think most are beginning to realize that to regulate effectively we must regulate reality not myth.

Throughout this process, Mr. Chairman, I look foward to working with you and all the members of the Committee.

The CHAIRMAN. Thank you, Senator Garn.

Senator Graham.

Senator GRAHAM. No opening statement.

The CHAIRMAN. Senator Hecht.

Senator HECHT. I have no opening statement.

The CHAIRMAN. In view of the fact that at least one of the first two witnesses on the panel of two which was scheduled next is understandably bogged down at Dulles Airport and can't get here on time, we will start off with the second panel, with two outstanding gentlemen, two of my bosses. Both come from Wisconsin. Gerald Levy, president of the Guaranty Savings & Loan Association in Milwaukee, on behalf of the United States League of Saving Institutions; and Robert Gaiswinkler, president of the National Savings & Loan Association of Milwaukee and chairman of the National Council of Savings Institutions.

Mr. Levy, go right ahead.

STATEMENT OF GERALD J. LEVY, PRESIDENT, GUARANTY SAVINGS & LOAN ASSOCIATION, MILWAUKEE, WI; ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. LEVY. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is Gerald Levy. I am president of the Guaranty Savings & Loan Association of Milwaukee and appear today on behalf of the U.S. League of Savings Institutions where I'm the immediate past chairman and have chaired a special task force to address the situation at the FSLIC.

The written statement we have submitted addresses the four additional legislative topics before you for consideration but I would like to devote this oral presentation to the FSLIC recapitalization question.

A copy of our task force report was submitted with our testimony. The report was adopted unanimously by our U.S. League board which consists of directors from every State. I believe our board is as representative a group as is possible to convene of institutions insured by the FSLIC, the audience most directly affected by legislation to recapitalize the deposit insurance fund.

We appreciate the priority this committee places upon the current financial problems of the FSLIC. The situation has changed somewhat since the proposals of last year. Most notably, it is clear that economic conditions vary significantly by State and local communities. We have found that the FSLIC caseload has become intertwined with the deepening economic depressions in various States which are creating major difficulties for both savings institutions and commercial banks.

You can see from the maps that we brought along the considerable similarity between States with economic problems, commercial bank failures, and savings and loans with earnings problems.

MORE FLEXIBLE APPROACH REQUIRED

The new situation requires a more flexible approach to the FSLIC's problems. The U.S. League proposes a two-pronged savings institutions self-help plan—self-help because it will restore the health of the FSLIC and well-managed institutions that operate in depressed economies without turning to the taxpayer or enlarging the Federal deficit or calling for Treasury funds or guarantees.

The first part involves a regulatory and supervisory approach to extend capital forebearance and to adopt generally accepted accounting principles [GAAP] for problem loans at well-managed institutions operating in the——

The CHAIRMAN. Mr. Levy, I'm sorry to interrupt. I should have told you in advance. Maybe you know this, but I should tell you so you know and others know—this won't be taken out of your time—that witnesses will have 5 minutes to make their oral statements, their full written statements will be printed in the record, we will question at length and then at the end if you want to make a 1 or 2 minute statement that we didn't cover in the questioning we would be delighted to have you do that. Go right ahead.

Mr. LEVY. All right. The first part involves a regulatory and supervisory approach to extend capital forebearance and adopt generally accepted accounting principles for problem loans at well-managed institutions operating in depressed areas. We have explained our specific suggestions to Chairman Gray at the Bank Board.

They borrow from the commercial bank regulators' policies for farm and energy area banks, an initiative prompted by this committee last spring. Experience demonstrates that time can heal wounds, especially where the institutions involved hold assets consisting primarily of loans secured by real estate value.

The forebearance suggestions of our report are very important to the health of the FSLIC. Permit me, however, to focus on our improvements of the legislative plan developed by the Treasury.

We suggest 2 years of bond issuing authority of up to $5 billion to provide upfront resources to the FSLIC while the Treasury plan calls for $15 billion. Repayment of the bonds under our self-help plan would come first from the dedication of the statutory 20 percent net income set aside of the Federal Home Loan Bank system rather than a $3 billion initial drain on the retained earnings of the system as recommended by the Treasury. Adjustments would be made to treat FDIC members of the Home Loan Bank equitably.

No one, the U.S. League or the Treasury, can forecast with accuracy the needs of the FSLIC in the years ahead. We have supported in large part regulatory steps dealing with brokered deposits, direct investments, and phased-in higher capital rules to contain future problems.

We applaud the chartering of the Federal Assets Disposition Association [FADA] to accomplish asset disposition in a businesslike way, and the replacement of management of problem institutions with the Management Consignment Program. The managerial strains on the agency are considerable with turnover at the policy level, staffing and hedging strategies at institutions with the consent of the Bank Board open to question.

The U.S. League believes the prudent approach is to limit the extraordinary upfront bond issuance to 2 years, at which point Congress can review the progress. By leaving in place the Home Loan Banks' retained earnings, there is flexibility for future borrowing at that point.

Our plan provides essentially the same resources to the FSLIC over the next 2 years as the Treasury version. It provides significantly more over the long term because the FSLIC would not be burdened with paying interest on two or three times as much borrowing.

PHASEOUT OF SPECIAL ASSESSMENT

In legislating in this area we urge the committee to include statutory language giving some hope that the extra one-eighth of 1 percent FSLIC special assessment can be phased out. Not only is the special assessment an extra competitive handicap, we pay two and a half times the rate of commercial banks, but together with the prospect of debt service on $15 billion in bonds, it encourages stronger savings institutions to migrate from FSLIC to FDIC insurance.

Any FSLIC recapitalization bill processed this year also needs to correct the problem with the FSLIC secondary reserve. It must establish industry oversight groups and assure periodic reports to this committee and its counterpart on the other side of the Capitol. Our written testimony explains once again why plugging the nonbank bank loophole, which is important for the integrity of the financial system, is also important for conserving resources of FSLIC.

We also ask your help with colleagues on the tax writing committees for extending sunset dates——

The CHAIRMAN. Can you finish it up in about 30 seconds?

Mr. LEVY [continuing]. Special code provisions essential to attracting bidders for supervisory mergers. The deadline pressure of these dates could force FSLIC into needless expense or resolution of problem cases and aggravate regional economic conditions.

[The complete prepared statement follows:]

STATEMENT OF
THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

PRESENTED BY
GERALD J. LEVY

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Gerald J. Levy. I am President of Guaranty Savings and Loan Association of Milwaukee, Wisconsin, and appear today to present the views of the U.S. League of Savings Institutions*.

I am immediate past chairman of the League and serve as chairman of its special task force on current issues confronting the Federal Savings and Loan Insurance Corporation, which provides federal deposit insurance coverage for approximately 3,000 of our member institutions. The complete text of our report has been provided with this statement.

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* The U.S. League of Savings Institutions serves the more than 3,400 member institutions which make up the $1.2 trillion savings association and savings bank businesses. U.S. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Joe C. Morris, Chairman, Emporia, Kansas; Theo H. Pitt, Vice Chairman, Rocky Mount, North Carolina; William B. O'Connell, President, Chicago, Illinois; and Phil Gasteyer, Executive Vice President and Director of Washington Operations. U.S. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

We appreciate the priority this distinguished Committee places upon the current financial problems of the FSLIC. The situation has changed somewhat since the first formal legislative proposals to provide additional funding were made early last year. Most notably, it is clear that economic conditions in our nation vary significantly by state and local communities.

Last year it was assumed that there was a limited, one-time bulge in the FSLIC's accumulated caseload that had to be dealt with on an extraordinary basis over the next few years. But, as our reactivated Task Force on FSLIC Issues reviewed the situation, we found that the FSLIC caseload has become intertwined with the deepening economic depressions in various states which are creating major difficulties for both savings institutions and commercial banks. Well-managed institutions are being overwhelmed by local economic conditions which resemble those of the 1930s. Credit-risk problems identified a year ago are no longer confined to commercial real estate; traditional single-family home loans are now turning up in the non-performing categories in some areas. (Maps and charts appearing among the exhibits in our task force's report demonstrate the close correspondence between: states with economic problems measured by unemployment, personal income and housing starts; states experiencing commercial bank failures in 1985 and 1986; and states where FSLIC-insured savings institutions lost money, on average, in the first half of 1986.)

Thus, the capital of many institutions is being temporarily eroded by operating losses from the lack of earnings on non-performing assets. These problems are being compounded by the use of regulatory accounting provisions known as the "classification of assets" regulation adopted by the Federal Home Loan Bank Board in January 1986. When combined with the depressed local economic environment, asset classification write-downs and strict adherence to a recently promulgated appraisal guideline mean that many sound institutions can be forced into insolvency.

The U.S. League believes that the new situation requires a new and more flexible approach to the FSLIC's problems. Thus, we propose a two-pronged "Savings Institutions Self-Help Plan."

First, we have asked the FHLBB to adopt the same flexible regulatory and supervisory policy approach already in place at the commercial banking agencies in order to provide for a capital and non-performing loan forbearance policy for well-managed institutions located in depressed economic areas.

Second, we propose for your consideration a modified legislative plan which resembles S. 45, as introduced by Chairman Proxmire and Senator Garn on January 6. Our modifications seek to make the statutory program more manageable and flexible, encourage periodic review by the Congress as conditions evolve, and provide a program sustainable by the anticipated resources of our industry in coming years.

Our program is first and foremost a "self help" plan. It will restore the financial health of the FSLIC and well-managed institutions operating in depressed economies without turning to the taxpayer, enlarging the federal deficit, or calling for Treasury funds or guarantees.

It is accomplished through the integrated regulatory, supervisory, long-term credit and depositor protection system comprised of the FHLBB, the FSLIC and the Federal Home Loan Bank System. The financial resources come entirely from regular and special assessments on FSLIC-insured institutions and use of an earnings set-aside of the Federal Home Loan Bank System, which is owned by our institutions (and some FDIC-insured savings banks, for which allowance has been made). Despite the mischaracterizations of others -- including some prominent government officials who should know better -- it is entirely "self help."

FORBEARANCE FOR INSTITUTIONS IN DEPRESSED AREAS

As our League has testified in the past, the U.S. League has been concerned about "high flyers" and the exposure they have created for the FSLIC fund. We have recognized, as has the FHLBB, that restoring the health of the FSLIC also involves imposing necessary regulatory and supervisory discipline -- to contain the possibility of recurrent exposure to loss through a growing caseload of institutions in receivership.

We have been generally supportive of the FHLBB's efforts to restrain acquisition of funds through deposit brokers, to require prior supervisory approval when direct investments (in real estate, securities and service corporations) exceed 10% of assets, and to embark upon a six-year program to bring regulatory capital to 6%. We have encouraged supervisory initiatives, including the replacement of managements at high flyers, putting institutions under a Management Consignment Program with expertise borrowed from soundly managed companies, minimizing losses on assets acquired through receivership by assigning them to the Federal Asset Disposition Association, establishment of a separate Bank Board-level Office of Enforcement, and deployment of examination personnel to the regional banks where they may more closely monitor the problem caseload and spot potential troubled institutions. Currently, the Bank Board has a special task force working on a reorganization plan for the FSLIC, which we commend.

While the regulatory and management initiatives just recited are helping, our Task Force recognized that regional and local economic conditions are creating operating problems even for traditional FSLIC institutions committed to thrift and home finance in their communities. These patterns, as noted, are not limited to our business, but are being experienced by commercial banks operating in depressed economies. In April 1986 the three federal commercial banking regulators issued a policy statement for well-managed banks located in areas heavily dependent upon agricultural or energy-related economies. They established a capital forbearance program, relaxed lending restrictions based on percentages of capital, and encouraged the use of generally accepted accounting principles (GAAP) which allow the carrying of low- or non-paying loans without writedowns which deplete capital. (The Comptroller of the Currency's version of the policy statement is attached to this testimony.)

With this model, our U.S. League Task Force recommends that the FHLBB take the following actions:

#- Direct its principal supervisory agents to exercise forbearance in handling well-managed institutions in trouble due to local economic conditions. In judging whether an institution is well-managed, the Principal Supervisory Agent (PSA) should determine that willful violations of laws and regulations, excessive growth or other irresponsible actions on the part of management, ownership or directors, did not contribute to an institution's distress.

#- Problem assets should be accounted for according to generally-accepted accounting principles. This involves the use of valuation standards consistent with GAAP in the carrying value of assets, appraisal discounting consistent with GAAP, and avoiding duplication with other "scheduled items" requirements (which would still apply to non-performing one-to-four-family home loans).

These regulatory and supervisory steps would create a "breathing space" beneficial not only to institutions, but to the FSLIC and to local economies. As detailed in our full report there is ample precedent for Congressional and regulatory forbearance initiatives involving financial intermediaries. The enactment of the Net Worth Certificate program developed by this distinguished panel in 1982 and the regulatory accounting provisions enacted last year for the Farm Credit System, as well as the commercial bank regulators' policy statement mentioned above, bear witness to previous prudent forbearance approaches.

Experience demonstrates that time can heal wounds --

especially where the institutions involved hold assets consisting primarily of loans secured by real estate values. For example, in the 1981-82 period, when our member institutions in the so-called "rust belt" experienced the most pronounced difficulties, tolerance and time have proved to be the best course of action. Institutions in New York had an aggregate return on assets of -1.51 percent in 1981 and 1982, and in Illinois, of -1.0 percent. By the first half of last year, thrifts in New York had an aggregate ROA of +1.18 and those in Illinois +1.12.

From the perspective a sound overall policy approach to restoring the health of the FSLIC, forbearance is particularly important for local economies in distressed areas. If well-managed institutions are placed in receivership unnecessarily -- and if their assets are liquidated at depressed values -- economic distress will be aggravated. Competing financial institutions which are still in operation will find their portfolio values degraded and the financial infrastructure of entire communities will be threatened. The Congress and the federal regulators must make every effort to minimize such a sequence of events.

A FUNDING PROPOSAL FOR THE FSLIC

In constructing legislative authority to rebuild the FSLIC reserves, a "self-help" solution must recognize the available resources of the thrift industry over the longer term as well as the size of the FSLIC's current problems and the agency's capacity to deal with them.

From the end of fiscal 1985 to the end of fiscal 1986, the FSLIC's reserves declined by $3.9 billion -- from $7.5 billion to $3.6 billion. However, as Exhibit 6 in our full report shows, the FSLIC had cash and government securities on hand of $4.6 billion at the end of September, 1986. During fiscal 1986, this figure declined by $1.1 billion. Because the FSLIC had income of $2.4 billion, this means it expended $3.5 billion during the year. During the same time period, the insurance fund showed an operating loss of $3.9 billion, but this was more than explained by $5.9 billion in accounting loss provisions.

To address the deteriorating situation, the Treasury developed the proposal essentially set forth as S. 45. The distinguishing characteristic of this approach is the borrowing of $10 to $15 billion over the next several years (using a financing corporation established for this purpose) to augment premium assessments and FSLIC portfolio investment income. In addition, to secure these massive borrowings, the FHLBank System would contribute $3 billion which would be used to purchase zero-coupon bonds to defease the principal of the bonds. To assure debt service, the financing corporation is given a first call on future deposit insurance premium flows.

Members of the Committee will recall that this complex funding plan attracted criticism from the Congressional Budget Office, which ruled last July that the borrowings could not be scored as government receipts for budget purposes and, as a result, spending the proceeds in resolving FSLIC problem cases would add to the federal deficit. Technical changes led to a reconsideration by CBO, which accepted the revised structure as a "close call."

As the savings institution business examined the legislative proposal of the Treasury, it too became concerned about the magnitude of the deficit spending through massive borrowings. In simple terms, our members questioned the need to "mortgage their future" by taking on the debt service of $10 to $15 billion flotations for up to 30 years. This may have some appeal to bond salesmen, but it imposed a continuing burden on an industry competing with other financial service providers while committed to a solution funded entirely by its own resources.

Our League explored various alternatives. One, known as the "pay as you go" plan, was criticized for not providing sufficient resources in the early years to handle the most immediate problems. Second, it was charged that if the FSLIC's problems proved larger than expected, there was no way in which more funds could be provided.

The Task Force which I chair sought to accommodate these criticisms in our meetings in recent weeks by fusing some elements of our "pay as you go" thoughts with a modest bonding approach. The result, which I present for your consideration, is a "Savings Institution Self-Help Plan for Funding the FSLIC."

Our approach contains four basic steps:

1. A funding corporation would be set up which would, if needed, issue zero-coupon bonds which would be repaid from the dedication for that purpose of 20% of net income that the Federal Home Loan Bank System currently sets aside in its so-called legal reserve (which is not available to pay dividends to thrift institution stockholders). The funding corporation could raise up to $2.5 billion in borrowing in the first year following enactment and another $2.5 billion in the second year. (The FHLBank contributions to debt service on this bonding would be adjusted for non-FSLIC shareholders.) If Bank System earnings fall short of our projections, FSLIC-insured institutions are prepared to make up the difference.

While explained in greater detail in our full report, the following table gives the total external resources available to FSLIC under this program in comparison with the plan of H.R.27 recommended by the Treasury:

FSLIC CASH FLOW FROM EXTERNAL SOURCES UNDER INDUSTRY SELF-HELP PROGRAM AND TREASURY/BANK BOARD PLAN

Cash Flow Over:	U.S. League Self-Help Program	Treasury/Bank Board Program $10 Billion in Borrowings	 $15 Billion in Borrowings
2 Years	$ 8.9 Billion	$ 8.7 Billion	$ 9.6 Billion
5 Years	$13.8 Billion	$16.8 Billion	$21.4 Billion
10 Years	$20.0 Billion	$19.0 Billion	$21.6 Billion
20 Years	$38.7 Billion	$29.7 Billion	$28.3 Billion

Our plan provides essentially the same resources to the FSLIC over the next two years as the Treasury's version; it provides significantly more over the long term because the FSLIC would not be burdened with paying interest on two or three times as much borrowing.

In addition to these external resources, the FSLIC earns investment income annually and should soon see an additional inflow of cash from the disposition work of the Federal Asset Disposition Association.

Also, it should be remembered that if the FSLIC were actually to spend more than $5 billion per year disposing of problem assets, there is a real possibility that it would be exacerbating its own problems, those of surviving savings institutions and of local economies. In addition, there is the lingering question as to whether the agency, without attracting permanent expertise for its top staff positions, can spend such enormous sums efficiently.

Another benefit of this approach, in comparison with the Treasury's model, is that it leaves the $2.2 billion in retained earnings of the FHLBank System intact, since it taps only the future income stream already set aside under the provisions of the Federal Home Loan Bank Act of 1932. This feature not only reduces the threat to ongoing FHLBank System fund-raising on Wall Street, but it conserves flexibility. If, for whatever reason, the authority granted by our approach proves inadequate, Congress could revisit the situation and utilize the System's retained earnings at a later date. Permit me to emphasize: savings institutions are understandably concerned about the higher debt service burden of the Treasury version.

Indeed, the League considers it appropriate that Congress review this situation periodically rather than leave open the administrative possibility of burdening the industry and its Bank System further with huge amounts of debt.

2. We would include a program for relieving FSLIC-insured institutions, over time, of the extra burden of the special 1/8 of 1% assessment which has been levied since the beginning of 1985. Under our plan, that special assessment would be phased out over six years. It is vital that savings institutions see some end to the special insurance assessment. An FSLIC-insured savings institution with the same structure as a competitor FDIC-insured bank pays at least two-and-one-half times as much for comparable federal account insurance. With the debt service burden of the Treasury/Bank Board plan, a phase-out of the special assessment is obviously less likely.

In addition to this inequity, the disparity encourages stronger savings institutions to migrate from FSLIC to FDIC insurance. Such a migration then depletes the overall resources of the FSLIC -- a particularly troublesome thought if FSLIC insurance also carries with it the obligation of continuing debt service for massive bonding, as under the Administration's plan.

3. Another provision we believe necessary is the repeal of unnecessary statutory language in the 1982 Garn-St Germain Act concerning authority to tap into the historic secondary reserve of the FSLIC before the primary reserve is depleted. This language has raised concerns among certain accounting professionals that the more than $800 million in secondary reserve balances carried as assets on the industry's books should be written off -- a corresponding reduction in industry net worth -- which, of course would aggravate the FSLIC's problems through the stroke of a pen. With the "self help plan" recommended by this testimony in place, there is no need to preserve the statutory phrase added in 1982.

4. Finally, our task force believes that any FSLIC funding legislation should include an oversight committee with representatives from FSLIC-insured institutions to monitor and make suggestions concerning agency plans and programs for spending and caseload resolution. In addition, the FSLIC should be required to report periodically to this Committee and its House counterpart on its utilization of funds.

A comprehensive legislative approach to relieve FSLIC's problems includes two additional topics -- one within the jurisdiction of your Committee and another where you could be of invaluable assistance.

TAX CODE PROBLEMS

Another important legislative issue involved with recapitalizing the FSLIC arises from sunset dates inserted in last year's Tax Reform Act. While we appreciate that such legislation falls within the jurisdiction of other congressional committees, your committee should appreciate the importance to the FSLIC of the tax code provisions cited below and you could be of great assistance in urging an extension of those dates. Allowing them to sunset, as now scheduled, creates still greater pressure for rushing into FSLIC-assisted supervisory mergers in the next two years -- magnifying local and regional economic problems.

The Economic Recovery Tax Act of 1981 included three emergency provisions in the Internal Revenue Code to assist the FSLIC. Sec. 597 made assistance payments from the FSLIC tax-exempt; Sec. 368(a)(3)(D)(ii) granted special tax-free reorganization treatment for troubled thrifts which don't meet a continuity of interest requirement after merger; and Sec.382(b)(7) sustained certain net operating loss carryovers from a troubled thrift for use by its rescuer. All three of these provisions make acquisitions of troubled thrifts more attractive to potential acquirers. However, despite the Administration's recommendation that they be continued for five years, last year's Tax Reform Act terminates them on Jan. 1, 1989 -- just two years distant.

The Chairman of the Federal Home Loan Bank Board has estimated that the savings to the FSLIC in attracting bidders for troubled thrifts is at least twice the cost in revenues foregone from these special tax code provisions. Not only would their repeal discourage supervisory mergers, but there is a very real possibility that -- as the January 1, 1989, date approaches -- the FSLIC will find itself forced to accept less favorable terms, with even greater costs to its reserves, to accomplish supervisory mergers.

We seek the good offices of this distinguished Committee in achieving a further, three-year extension of these three special tax code provisions of particular importance to the FSLIC. Furthermore, given the mounting problems confronting the Federal Deposit Insurance Corporation, consideration should be given to extending their coverage to assist in the resolution of problem cases confronting that agency.

THE NONBANK BANK QUESTION

Also closely related to the resolution of the FSLIC's problems is the familiar topic of settling the uncertainty in the Bank Holding Company Act known as the "nonbank bank loophole." The continued operation of and potential for loophole banks, operating outside the regulation of the holding company laws with privileged activities' flexibility and geographical expansion opportunities, obviously threatens the stability of existing depository institutions and the payments system. Continued exploitation of the loophole is an even greater problem in the context of conserving the resources of the FSLIC fund.

The most cost-effective way to resolve FSLIC's problem caseload is to arrange supervisory mergers for troubled institutions. If potential merger partners of troubled thrifts can enter new markets or obtain a depository charter through the loophole route, there is little incentive to bid on the FSLIC's problem cases. Plugging the loophole would be of tremendous assistance to the FSLIC and our institutions which stand ready through our self-help plan to restore its reserves to full health.

As you are well aware, the U.S. League has long been supportive of legislative attempts to close the nonbank bank loophole. We, in fact, believe that any plan to recapitalize the FSLIC may well fall short of its potential unless the nonbank bank loophole is immediately and permanently closed.

The proliferation of nonbank banks has seriously undermined the FSLIC's resolution of problem cases because of its inability to attract serious acquirers of weakened thrifts. Since 1982, the Bank Board had considerable success under the emergency acquisitions provisions of the Garn-St Germain Act in marketing problem cases to entities that wished to use those provisions to accomplish interstate or other transactions that otherwise would have been statutorily or regulatorily impermissible. Naturally, the attractiveness of a savings institution charter is diminished in comparison with the ability to operate an institution which is allowed to operate free from activities and geographic restraints, but has virtually all the same benefits as a bank. Such entities have a very substantial degree of investment flexibility with both commercial and residential loans and receive FDIC insurance and access to the Federal Reserve discount window. In testimony before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance in 1985, Federal Home Loan Bank Board Chairman Gray said the most critical problem nonbank banks pose to thrift institutions is the "disincentive for companies to acquire failing thrifts." Now, in 1987, that observation has special relevance as the FSLIC faces a full slate of problem cases.

Because of the Bank Board's difficulties with marketing problem institutions under the emergency acquisitions authority of the Garn-St Germain Act, it adopted a rule permitting supervisory case rescuers to apply for branches in two or more states in addition to the target location. We have had concerns over such a rule and would prefer to see Congress close the loophole so that the FSLIC might again attract new prospects to the industry.

Specifically, we support a redefinition of the word "bank" for Bank Holding Company Act enforcement purposes. Such legislation should also define a bank as any FDIC-insured institution which accepts demand deposits and engages in commercial lending. Furthermore, the U.S. League believes strongly that any such legislation should be made retroactive.

An additional problem which has arisen in dealing with the issue of nonbank banks is the myth that any closing of the loophole must be accompanied by severe limitations on acquisitions of savings institutions and registration as a savings and loan holding company. The Garn-St Germain Act declares clearly that as long as a savings institution subsidiary remained committed to housing finance there is no point in applying bank holding company-like activities restrictions to acquirers. To our knowledge, no abuses have resulted from the unitary savings and loan holding company format. Indeed, it is essential that our specialized depositories committed to long-term home finance attract outside capital. In additional to the "thriftness" test, I would also point out that the Savings and Loan Holding Company Act contains several unique and stringent prohibitions on transactions between affiliates to assure against misuse of the thrift subsidiary.

We urge this distinguished Committee to revisit legislation clarifying the definition of "bank" in the Bank Holding Company Act, thus plugging the loophole, at the earliest possible opportunity.

THE "REGULATORS' BILL"

Mr. Chairman, your invitation to testify also invites our comments on the Financial Institutions Emergency Acquisitions Amendments, or the regulators' bill.

It is our understanding that the most recent versions of the Senate legislation, passed twice in the final day of the second session of the 99th Congress, would have extended and strengthened the federal bank regulators' authority to arrange the interstate acquisition of failed and failing banks and bank holding companies by out-of-state banks. It would also have lowered the threshold measurement for eligibility for both closed and failing banks from $500 million to $250 million and provided authority for the FDIC to establish bridge banks to take over the assets and liabilities of a failed bank and to carry on its business for a limited period of time.

In testimony before both your Committee and the House Banking Committee, the U.S. League has expressed its general support for the legislation. Although we are not privy to the magnitude of the problems which led the federal commercial banking regulators to ask for this statutory assistance, we are well aware of the problems faced by banks and bank holding companies in the depressed oil and gas-producing and farm economies. For this reason, the U.S. League's FDIC Liaison Committee has studied the legislation and gone on record as supporting the extension and liberalization of the emergency acquisition provisions of the Garn-St Germain Act.

As you know, the availability of the extraordinary powers, together with the enactment of the Net Worth Certificate Act, has contributed importantly to the thrift industry's recovery -- particularly in the Northeast -- with only a minimum cost to the federal deposit insurance agencies. We are confident that the current members of the FDIC Board will continue to take only those actions which are absolutely necessary. Further, such powers would permit the FDIC to resolve problems involving banks with serious and identifiable financial difficulties before those problems reach the state when they require federal financial assistance. This would reduce the potential demand on the FDIC's resources and, in turn, increase the likelihood that the agency will not exhaust its resources. The public's confidence in our financial institutions depends of successful resolution of these problem cases.

Although the House and Senate versions of the regulators' bill were substantially similar, the Senate version contained the authority for the FDIC to operate bridge banks until a rescuer could be found. We liken this program to our very successful Management Consignment Program and would hope that this authority would be contained in the final version of the legislation.

We would like to make some additional comments about the regulators' bill:

#-- We strongly encourage Congress to extend the emergency acquisitions and the Net Worth Certificate authority of Garn-St Germain for five more years -- until 1991 (this authority expired October 13, 1986 and was not extended before Congress adjourned). At a minimum, the authorities should be extended to February 1, 1988;

#-- We would hope that the Committee would provide greater precision in framing two of the three standards found in the definition of a "failing" bank: a bank "unable to meet its obligations" is too vague and "other grounds" under applicable State law might result in closures for technical violations;

#-- We agree with the provisions to require a unanimous vote by the FDIC Board when FDIC assistance is involved along with the requirement that state bank supervisors be consulted and be granted the right to object to the use of the new authorities.

SOUTH DAKOTA LOOPHOLE

The U.S. League agrees that it is unfair for State laws to invite headquarters for nationwide activities not permitted bank holding companies so long as the activities are not conducted in-State. We therefore would support closing the South Dakota loophole, but not to the extent that important State authorities are compromised. It is our opinion then, that State banks, owned by bank holding companies, should be allowed to engage in such activities when they are authorized by the legislature of the State in which those activities are to be followed, provided that both the bank and its owning bank holding company are in-State institutions and the activities are conducted in-State or otherwise in accordance with the Bank Holding Company Act.

NEW POWERS FOR BANK AND S&L HOLDING COMPANIES

For the past two Congresses it has been the Senate's will to authorize expanded powers for bank and S&L holding companies. In 1984, the Senate approved legislation which would have provided authority for bank and S&L holding companies to underwrite revenue bonds, commercial paper and mortgage-backed securities. Last year's S. 2592 included a title which would have granted similar expanded securities powers for bank and S&L holding companies through authorization of Depository Institution Securities Affiliates (DISAs). Also included in the powers was the authority to sponsor and operate mutual funds. The House, however, has been unwilling to consider financial institutions legislation which includes any expanded powers.

The U.S. League has agreed with the Senate's will in authorizing the above additional powers for bank and S&L holding companies on the basis that they are safe activities for financial institutions to engage in. We have advocated that any additional powers be extended to savings institutions and their holding companies as a matter of parity with other financial service providers. Such powers would include, but not be limited to, the above authorities plus:

#-- The removal of barriers to acceptance of unrestricted demand accounts to individuals and corporations by federally chartered savings institutions;

#-- Authority for federally chartered savings institutions to invest, in the aggregate, up to 10% of assests in direct real estate investment, equity securities and service corporations;
#-- Authority to pay interest on ordinary demand accounts for individuals and corporations;
#-- Authority for federally chartered savings institutions to trustee corporate retirement plans;
#-- Authority for the creation of mutual thrift holding companies.

CHECK-HOLD LEGISLATION

While the U.S. League is sympathetic with consumer concerns over excessively lengthy holds on deposits, we continue to believe that deposit hold policies are necessary to prevent excessive loss to financial institutions offering NOW accounts, demand accounts and other deposit accounts. We also believe that ultimately, the solution to any concern consumers may have regarding delayed access to deposited funds is to eliminate, as much as possible, the need for the customer to physically deposit checks to his or her account. This can be accomplished if customers are able and willing to have checks of all types -- payroll, government, dividend, etc. -- deposited electronically to their accounts. However, we realize that the availability and consumer acceptance of electronic direct deposit in the United States currently lags far behind that of other industrialized nations and will take more time until full acceptance and utilization is achieved.

We would like to point out that although most savings institutions place holds on checks deposited by customers, the effect is of little consequence to most customers. Many of the publicized abuses have occurred primarily with checking accounts at commercial banks. Furthermore, whether or not they place a hold on a deposited check, most savings institutions pay interest on such funds from the date they are deposited. Moreover, the customer earns interest on these funds even though the institution may have to wait as much as a week to receive the proceeds of the check in a form which allows the institution itself to begin earning income on the funds.

In the last Congressional session, the House and Senate responded to consumer concerns with different proposals. In January, 1986, the House overwhelmingly approved H.R. 2443, the Expedited Funds Availability Act, which established an elaborate timetable of restrictions on check holds. Your chamber, on the last day of the session, elected to pass provisions which would have provided for increased disclosure of check hold policies and required the Federal Reserve to expedite check clearing procedures within 18 months. It is our understanding that the check hold provisions were substantially similar to title V of S. 2851, the Financial Services Competitive Equity Act of 1984 which was approved by the Senate on an 89-5 vote.

Although the House bill was amended on the floor to provide institutions with discretionary leeway where reasonable doubt of collection might exist, the U.S. League prefers the disclosure approach and its accompanying instruction to the Federal Reserve System which was adopted by the Senate. We generally support increased disclosures of check hold policies, but we would like to note that the various financial institution regulatory agencies have encouraged depository institutions to disclose deposit practices. In March, 1984, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Federal Reserve Board issued a joint policy statement requesting financial institutions to "voluntarily ameliorate the problem of delayed availability of funds." It further requested institutions to review their policies with the objective of "reducing delays consistent with prudent business practices, disclosure of funds availability policies to customers and refraining from imposing delays across the board, specifically delays on Social Security and other government checks deposited in established accounts."

During the last two years, the agencies have been monitoring the effectiveness of voluntary action and have conducted consumer surveys. If the agencies determined that voluntary actions were inadequate, further action would be taken. To date, no further action has been taken by the Bank Board. It is the League's belief, therefore, that widespread abuses by savings institutions are not occurring, and that no federal legislation using a disclosure pattern is all that is necessary at this time. Finally, we would caution that, if Congress determines that restrictions are necessary, a reasonable mechanism should be provided by which a receiving institution can protect itself from losses through check kiting or other such fraudulent practices.

CONCLUSION

I have appreciated this opportunity to present the views of the U.S. League on these issues of overriding importance to our FSLIC-insured member institutions. This is particularly so of the FSLIC refunding debate. We are confident that a reasoned and coordinated regulatory and supervisory approach can accommodate the challenge of sustaining our institutions devoted to thrift and homeownership in the various regions of our great nation experiencing temporary economic distress.

Furthermore, we submit for your consideration a "self-help" legislative plan to bolster the reserves of our insurance fund in a way which will be sustainable by our industry and the FHLBank System owned by our thrift business. We do not seek the appropriation of taxpayer funds to solve the FSLIC's problems.

Thank you for your consideration of our views. I look forward to your questions.

condition. The following are examples of such types of loans: For growing and storing of crops, breeding and marketing of livestock, financing fisheries, purchases of farm machinery and equipment, maintenance and operations of the farm, and discounted notes of farmers.

(2) "Oil and gas loans" include loans or extensions of credit to oil companies, petroleum refiners, and companies primarily engaged in the oil- and gas-related business, for example: Operating oil and gas field properties, contract drilling, performing exploration services on a contract basis, performing oil and gas field services, manufacturing or leasing of oil field machinery and equipment, pipeline transportation of petroleum, natural gas transmission or distribution, and investing in oil and gas royalties or leases.

(3) "Special category loan charge-offs" mean agricultural or oil and gas loans charged-off during the period from January 1, 1986 through December 31, 1987, which have been or will be reported in a special memorandum item in the bank's call report of condition in accordance with the Comptroller's capital forbearance policy.

(b) A national bank which has special category loan charge-offs resulting in a reduction in its unimpaired capital and unimpaired surplus since December 31, 1985, may substitute a lending limit calculated under this section for the general limitation provided at 12 U.S.C. 84(a)(1), up to a maximum amount of 20 percent of unimpaired capital and unimpaired surplus, until January 1, 1993.

(c) The substitute lending limit in section (b) is the lesser of the following amounts:

(1) 15 percent of unimpaired capital and unimpaired surplus on December 31, 1985; or

(2) 15 percent of the total of:

(i) The difference between the sum of special category loan charge-offs and the sum of recoveries on those charge-offs; plus

(ii) Unimpaired capital and unimpaired surplus; or

(3) 20 percent of unimpaired capital and unimpaired surplus.

Dated: April 4, 1986.

Robert L. Clarke,

Comptroller of the Currency.

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12 CFR Part 32

[Docket No. 86-10]

National Banks; Capital Forbearance Policies

AGENCY: Office of the Comptroller of the Currency, Treasury.

ACTION: Policy Statement on Capital Forbearance.

SUMMARY: Conditions in the farm and oil and gas sectors of the economy have created increasingly severe financial pressures on farm banks and their farmer borrowers and on oil and gas banks and their oil and gas borrowers. Many farmers are facing foreclosure, and others have developed serious problems. Likewise, the volatility of energy prices has created difficulties for oil and gas borrowers.

Recognizing these problems, the Office of the Comptroller of the Currency ("OCC") is publishing this policy statement which explains its intentions with regard to supervisory policies affecting national banks adversely affected by economic conditions in the agricultural and oil and gas sectors of the economy. This statement was issued in Banking Circular No. 212, dated March 28, 1986. The statement outlines a short term capital forbearance policy designed generally to benefit agricultural and oil and gas banks having sufficient capital to absorb loan losses and reasonable prospects to replenish capital; it reiterates previous OCC statements regarding loan restructuring and accounting therefore; it describes proposed call report changes expected to be effective with the call report for the quarter ending June 30, 1986; and it announces OCC's intention to amend 12 CFR Part 32 relating to lending limits to substitute a new lending limit to offset the impact lower capital ratios would otherwise have on lending limit computations at national banks making agricultural and oil and gas loans.

EFFECTIVE DATE: March 28, 1986.

FOR FURTHER INFORMATION CONTACT: Alan Herlands, Special Assistant to the Chief National Bank Examiner, (202) 447-1646, or Zane Blackburn, Director, Bank Accounting, (202) 447-0471, 490 L'Enfant Plaza East, SW., Washington, D.C. 20219.

SUPPLEMENTARY INFORMATION:

I. Introduction

The last few years have proved to be a particularly difficult period for farm and oil and gas banks and their borrowers. Many farmers and others dependent on the agricultural economy have experienced, and continue to experience, financial difficulties. During this period, an historically large number of farm banks have failed and an even larger number have developed serious problems. Similarly, volatile energy prices have adversely impacted oil and gas borrowers and the banks that lend heavily to them.

In light of these problems, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation believe it appropriate to employ supervisory policies that will support basically sound, well-managed banks in weathering what is expected to be a difficult but transitional period. In connection with their recent testimony before Congress, the agencies released a Joint Policy Statement on March 11, 1986, outlining these policies. Although the statement refers only to agricultural banks, it has been extended to oil and gas banks by subsequent agreement among the agencies. A copy of the Joint Policy Statement is attached.

This Circular explains how the Office of the Comptroller of the Currency will implement the Joint Policy Statement. Implementation will be accomplished by encouraging banks to work with their troubled agricultural and oil and gas borrowers; by establishing a capital forbearance policy; by encouraging the use of generally accepted accounting principles which may permit loan restructurings without loss recognition; by changes to Call Reports; and by relaxing lending limits.

The Congress is considering legislation covering capital forbearance, Call Reports, and lending limits, among other matters. Modification of this Circular may be required if legislation is enacted.

Certain provisions contained in this Circular are subject to approval by the Office of Management and Budget, where they are currently under review.

II. Bank Relationships with Troubled Borrowers

Problems in the agricultural economy have directly affected the banks that provide financing for the agricultural sector. Severe financial pressures on borrowers dependent on the agricultural economy have resulted in an increase in loan delinquencies. As conditions have worsened, borrowers increasingly fear foreclosure, while bankers are increasingly concerned about supervisory actions that may result from

reduction in their banks' capital as a consequence of loan losses.

In response to this situation, the OCC has encouraged bankers to develop work-out strategies with their agricultural borrowers. In a joint statement on April 23, 1985, the Federal bank regulatory agencies reiterated their policy of encouraging banks to enter into work-out plans with agricultural borrowers who are experiencing temporary difficulties in meeting their debt service obligations. The OCC renews that encouragement now.

Although OCC examiners will point out to management the weaknesses that may be present in loans, the OCC does not require foreclosure on collateral or the acceleration of the maturity of loans. The OCC recognizes that downturns in certain sectors of the economy are expected to be transitory. Therefore, lenders may find that the most prudent policy is to restructure the loan terms rather than to take more precipitous action such as foreclosure.

The volatility in energy prices has created a similar situation between oil and gas companies and the banks that lend to them. Accordingly, the OCC also encourages banks to develop appropriate work-out strategies with their oil and gas borrowers.

III. Capital Forbearance Policy

Despite the difficult problems facing many agricultural and oil and gas banks, the OCC believes that most have sound prospects for the future. Even with the losses suffered by these banks and the likelihood that losses will continue to occur, these banks retain substantial strength. Many of them possess strong capital to asset ratios and capable management that adheres to sound lending policies.

Accordingly, the OCC has adopted, effective immediately, a capital forbearance policy which will benefit basically well-managed banks that have sufficient capital to absorb loan losses and reasonable prospects to replenish capital. Capital forbearance formally acknowledges that capital should be used during periods of unusually heavy loan losses and that capital replenishment takes time. The capital forbearance policy should provide banks greater incentives to recognize promptly losses arising in their loan portfolios, work with borrowers to restructure loans, and rebuild bank capital in an orderly manner. This capital forebearance policy is temporary and will terminate on January 1, 1993.

Under the capital forbearance policy, the OCC will not take administrative action to enforce the minimum capital requirements in 12 CFR Part 3 against a bank whose primary capital ratio declines below 5½ percent to no less than 4 percent before December 31, 1987, provided the bank meets the following qualifications and conditions.

1. The bank must meet the definition of an agricultural/oil and gas bank. An agricultural/oil and gas bank is one whose agricultural and oil and gas loans, in the aggregate, are equal to or greater than 25 percent of the bank's total loans and leases, net of unearned income. Agricultural loans are defined as loans secured by farmland and loans to finance agricultural production and other loans to farmers from Schedule C on the bank's Call Report. A list of the kinds of loans qualifying as oil and gas loans for purposes of the capital forbearance policy is attached as Exhibit A.

2. The weakened capital position of the bank must be largely the result of problems in the agricultural and/or oil and gas sectors of the economy and not due to excessive bank operating expenses, insider abuse, excessive dividends or actions taken solely for the purpose of qualifying for capital forbearance.

3. The bank must be well-managed. In reaching determinations about the quality of a bank's management, the OCC will take into account existing management's past record of performance in guiding the bank, including its timely recognition of loan losses and other weaknesses. The OCC will also consider the bank's past compliance with any agreements with, commitments to, or orders from the OCC. Further, the OCC will consider the capability of management to develop and implement an acceptable rehabilitative plan.

4. The bank must submit an acceptable plan for restoring capital by January 1, 1993 to the minimums required by 12 CFR Part 3. The plan should describe the means and schedule by which capital will be increased. This plan should also specifically address reduced dividends levels; limitations on the compensation of directors, executive officers or individuals having a controlling interest; limits on asset growth; and payments for services or products furnished by affiliated companies.[1] The plan should provide for improvement in the bank's primary capital ratio on a continuous or periodic basis from earnings, capital injections, asset shrinkage, or a combination thereof. A plan which projects no significant improvement in capital until near the end of the forbearance period will not normally be acceptable. The OCC may require modification to a bank's plan in order for the bank to receive, or to continue to receive, capital forbearance.

5. The bank must commit to file annual progress reports regarding compliance with its capital plan. Depending on an individual bank's progress, more frequent reports may be required. Moreover, any contemplated actions that would represent a material variance from the capital plan must be submitted to the OCC for review.

Banks with capital below the minimums established in 12 CFR Part 3 seeking capital forbearance must file a written request no later than December 31, 1987 with the Deputy Comptroller for the District in which the bank is located. The request must include a certification and explanation of its eligibility to participate (covering items 1 through 3 above), its plan, and its commitment to file the required reports. Capital forbearance will be considered granted unless, within 60 days of receipt of the request, the District notifies the bank that its request has been denied or that additional information or time is required. Pursuant to 12 CFR 3.8, during the period covered by this capital forbearance policy, a bank granted capital forbearance and in compliance with an acceptable capital plan will not be considered in violation of the minimum capital ratios required by 12 CFR 3.6.

Upon the written request of an agricultural/oil and gas bank and at the discretion of the OCC, the capital forbearance policy may be extended, in special circumstances, to a bank with a primary capital ratio lower than 4 percent. In addition, the OCC will consider extending its capital forbearance policy to banks which do not meet the above definition of an agricultural/oil and gas bank, but nevertheless are suffering capital declines caused by problems in the agricultural or oil and gas sectors. Capital forbearance may be extended to these banks only on a case-by-case basis upon written request and explanation submitted to the District Deputy Comptroller. In both circumstances, capital forbearance will not be considered granted until the District so notifies the bank.

The OCC reserves the right to terminate capital forbearance for banks engaged in unsafe or unsound or other objectionable practices, or if it becomes apparent to the OCC that the bank is unwilling or unable to comply with an acceptable capital plan. Capital forbearance, once granted, will not be terminated solely on the basis of subsequent changes in a bank's percentage of loans to agricultural and/or oil and gas borrowers.

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[1] Banks should also refer to Banking Circular No. 115, "Income Diversion Through Management and Other Fees", dated August 30, 1978, and Supplement No. 1 thereto, dated December 28, 1978.

Some banks are at present subject to capital requirements higher than those specified in 12 CFR Part 3 by a capital directive, an effective order issued pursuant to 12 U.S.C. 1818, or a formal agreement between a bank and the OCC. Banks which have experienced agricultural or oil and gas losses and which are subject to a capital ratio higher than the minimums set forth in 12 CFR 3.6 may request a modification from the OCC. The OCC will reconsider the higher requirement in light of the capital forbearance policy.

In addition, the OCC capital forbearance policy extends to well managed banks whose primary capital ratios decline, as a result of problems in the agricultural or oil and gas sectors of the economy, from historic levels to levels above the 5½ percent minimum primary capital ratio. These banks do not have to apply for capital forbearance, and the OCC will not require them to take any action solely on the basis of that decline in capital. These banks will be expected to maintain adequate capital for the nature of their operations and, if appropriate, to increase their capital over time back to historic levels. In addition, these banks must recognize that asset growth should be accompanied by appropriate increases in capital.

All banks which are operating with capital levels below those which would be expected under normal economic conditions should be aware that the OCC will be unlikely to approve applications by them to acquire other banks. Similarly, the OCC will be likely to object to changes in control or acquisitions of such banks unless the transaction will result in prompt restoration of capital to appropriate levels.

The implementation of the OCC's capital forbearance policy has no effect on balance sheet or income statement items reported in Call Reports or other financial statements, nor does it allow banks to report, as assets, loans (or portions thereof) considered losses. On the contrary, the policy retains existing financial presentation rules and creates no inconsistencies with generally accepted accounting principles. The OCC believes that maintaining the integrity of financial statements is vital to assuring confidence in the banking system.

IV. Accounting for Troubled Debt Restructurings

The OCC has followed, and will continue to follow, generally accepted accounting principles with respect to loans which have been formally restructured to enable the borrower to service the debt. Statement of Financial Accounting Standards No. 15 (FAS 15), Accounting by Debtors and Creditors for Troubled Debt Restructurings, governs the accounting for such restructurings. This Standard allows a loan to continue to be carried on the bank's books without any loss recognition if the loan is formally restructured in a manner so that it is probable and estimable that the borrower can repay the loan under the new terms, and that the total future cash payments by the borrower (principal and interest combined) at least equals the loan amount on the bank's books.

Accordingly, a bank which reasonably expects a borrower's future cash payments to equal or exceed the loan amount does *not* need to recognize a loss on the restructuring. In those situations where it is expected that the future cash payments on the restructured loan will be less than the loan amount, the loss recognized is limited to the expected cash flow deficiency.

[Banking Circular 195 includes more specific details of the accounting provisions.] Bankers are encouraged to familiarize themselves with the accounting treatment described in FAS 15.

V. Call Report Changes

Two changes are being made to the Call Reports, expected to be effective with the reports for the quarter ending June 30, 1986. One is needed to monitor the capital forbearance policy and potential changes to legal lending limits for national banks; the other is designed to prevent misconceptions about certain restructured loans.

Schedule RI-B, "Charge-offs and Recoveries and Changes in Allowance and Lease Losses," will be changed for national banks to provide information relative to capital forbearance and legal lending limits. Memorandum items will be added to this schedule to identify a bank's charge-offs and recoveries of Special Category Loans on a cumulative basis since January 1, 1986. Special Category Loans are defined as (a) loans secured by farmland and loans to finance agricultural production and other loans to farmers from Schedule C of the bank's Call Report and (b) the oil and gas loans listed on Exhibit A hereto. Should the definitions change, the OCC will provide national banks with revised definitions prior to the due date for the Call Report first affected by the change.

The second set of changes involves the reporting of renegotiated "troubled" debt. The existing Schedule RC-N ("Past Due, Nonaccrual, and Renegotiated Loans and Lease Financing Receivables"), will be modified by removing the column entitled "Renegotiated troubled debt." Renegotiated loans which are performing in compliance with the modified terms will be reported in the memorandum section of Schedule RC-C under a new heading "Loans Restructured and in Compliance with Modified Terms." Renegotiated loans that become past due or are otherwise placed in nonaccrual status will be reported in Schedule RC-N in the appropriate categories.

In addition, a new memorandum item will be added to Schedule RC-N to require reporting of total renegotiated "troubled" debt included in the categories 30-89 days past due and accruing, 90 days or more past due and accruing, and nonaccrual. This memorandum item will be maintained for supervisory purposes on a confidential basis.

VI. Lending Limits

The recognition by a bank of losses on loans reduces not only its capital, but also reduces the maximum amount the bank can lend by law to any single borrower. Lending limits are an important ingredient in protecting the safety and soundness of banks by requiring diversification of credit risks. Many banks have established internal controls limiting the size of loans to any single borrower to an amount less than the legal lending limit. In those banks that do make loans at the legal lending limit, such loans are generally small in number. However, the declines in capital attributable to the problems in the oil and gas and agricultural sectors of the economy may cause some banks to be unable to serve the normal credit needs of a greater number of their creditworthy customers. In order to reduce the impact of these loan losses on a bank's ability to meet the legitimate credit needs of its financially sound customers, the OCC believes it necessary and appropriate to relax lending limits during the period in which the capital forbearance policy is in effect.

The Federal statute governing national bank lending limits is 12 U.S.C. 84. The OCC has issued implementing regulations at 12 CFR Part 32. In general, national banks are subject to a *General* limitation of 15 percent of total capital

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(i.e., unimpaired capital and unimpaired surplus), and may lend an additional 10 percent of total capital to the same borrower fully secured by readily marketable collateral. There are also a number of exceptions for specified types of loans. Under the statute, the OCC has the authority to establish limits other than those specified.

Under that authority, the OCC contemplates adopting as soon as possible a temporary amendment to 12 CFR Part 32 to be consistent with the purposes of the capital forbearance policy. It is anticipated at present that the amendment would substitute an increased general lending limit for national banks to offset the decline in capital resulting from losses attributable to problems in the agricultural and oil and gas sectors of the economy. As an offset, the new general lending limit would not increase any bank's lending limit above what it would have been had it not experienced losses attributable to these troubled economic sectors. The OCC also contemplates including in the amendment a maximum general lending limit of 20 percent to preserve the benefits of risk diversification. The change would cover losses occurring after January 1, 1986 and no later than December 31, 1987, but the effect of those losses on lending limits would continue until January 1, 1993.

The change would allow banks, whose capital declines by no more than 25 percent as a result of losses attributable to agricultural and oil and gas loans, a general lending limit of 15 percent of their capital as of December 31, 1985. For example, a bank with a 10 percent capital ratio, whose capital ratio at December 31, 1985 subsequently declines to 8 percent as a result of losses attributable to the agricultural or oil and gas sectors, would have no reduction in its general lending limit. For banks whose capital ratios are even more dramatically reduced, the effect of the new provision would be a general lending limit of as much as 20% of their reduced capital. The new general lending limit rule would expire simultaneously with the capital forbearance policy on January 1, 1993. Comment will be solicited on the temporary amendment.

Exhibit B hereto is a worksheet which would enable national banks to compute their general lending limits under the new rule. The Comptroller will send appropriate material to national banks relating to the formal adoption of the change to 12 CFR Part 32. *The new lending limit will not be effective until formal adoption of the rule.*

Dated: March 28, 1986.

Robert L. Clarke,

Comptroller of the Currency.

Exhibit A—Definitions of Oil and Gas Loans

The types of loans listed below regardless of purpose will be considered oil and gas loans for the purposes of qualifying for capital forebearance. Wherever "company" is referenced, the caption also assumes "individuals". SIC stands for Standard Industry Codes. See following pages for definitions.

A. Loans to the major integrated oil companies;

B. Loans to companies engaged in operating oil and gas field properties (SIC 1311) (production);

C. Loans to companies primarily engaged in contract drilling (SIC 1381);

D. Loans to companies primarily engaged in performing exploration services on a contract basis (SIC 1382);

E. Loans to companies primarily engaged in performing oil and gas field services (SIC 1389);

F. Loans to petroleum refiners (SIC 2911);

G. Loans to manufacturers and lessors of oil field machinery and equipment (SIC 3533, 7394);

H. Loans to companies primarily engaged in pipeline transportation of petroleum (SIC 4612, 4613);

I. Loans to companies primarily engaged in natural gas transmission or distribution (SIC 4922, 4923, 4924);

J. Loans to companies primarily engaged in investing in oil and gas royalties or leases (SIC 6792);

K. Loans to others engaged in oil and gas related activities.

Major Integrated Oil Companies

International Companies

British Petroleum Co.
Chevron Corp.
Exxon Corp.
Gulf Oil Corp.
Mobil Corp.
Royal Dutch/Shell Group
  Royal Dutch Petroleum Co.
  Shell Oil Co.
  Shell Canada Ltd.
  Shell Transport & Trading Co.
Texaco, Inc.

Domestic Companies

Amerada-Hess
Ashland Oil Co.
Atlantic Richfield Co.
Kerr McGee Corp.
Occidental Petroleum Co.
Pennzoil
Phillips Petroleum Co.
Standard Oil Co. of California
Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
Sun Company, Inc.
Tenneco Co.
Unocal

SIC CODES

SIC 1311—Crude Petroleum and Natural Gas

Establishments primarily engaged in operating oil and gas field properties. Such activities include exploration for crude petroleum and natural gas; drilling, completing, and equipping wells; operation of separators, emulsion breakers, desilting equipment; and all other activities in the preparation of oil and gas up to the point of shipment from the producing property. Also includes the production of oil through the mining and extraction of oil from oil shale and oil sands.

SIC 1381—Drilling Oil and Gas Wells

Establishments primarily engaged in drilling wells for oil or gas field operations for others on a contract, fee, or similar basis. Includes contractors that specialize in "spudding in," "drilling in," redrilling, and directional drilling.

SIC 1382—Oil and Gas Field Exploration Services

Establishments primarily engaged in performing geophysical, geological, and other exploration services for oil and gas on a contract, fee or similar basis.

SIC 1389—Oil and Gas Field Services

Establishments primarily engaged in performing oil and gas field services, for others on a contract, fee, or similar basis, such as excavating slush pits and cellars; grading, and building of foundations at well locations; well surveying; running, cutting, and pulling casings, tubes, and rods; cementing wells; shooting wells; perforating well casing; acidizing and chemically treating wells; and cleaning out, bailing, and swabbing wells.

SIC 2911—Petroleum Refining

Establishments primarily engaged in producing gasoline, kerosene, distillate fuel oils, residual fuel oils, lubricants and other products from crude petroleum and its fractionation products, through straight distillation of crude oil, redistillation of unfinished petroleum derivatives, cracking or other processes.

SIC 3522—Oil Field Machinery and Equipment

Establishments primarily engaged in manufacturing machinery and equipment for use in oil and gas fields.

SIC 7394—Equipment Rental and Leasing Services

—Oil field equipment rental
—Oil well drilling equipment rental: Machinery, drilling bits, etc.

SIC 4612—Crude Petroleum Pipe Lines

Establishments primarily engaged in the pipe line transportation of crude petroleum.

SIC 4613—Refined Petroleum Pipe Lines

Establishments primarily engaged in the pipe line transportation of refined products of petroleum, such as gasoline and fuel oil.

SIC 4922—Natural Gas Transmission

Establishments engaged in the transmission and/or storage of natural gas for sale.

SIC 4923—Natural Gas Transmission and Distribution

Establishments engaged in both the transmission and distribution of natural gas for sale.

SIC 4924—Natural Gas Distribution

Establishments engaged in the distribution of natural gas for sale.

SIC 6792—Oil Royalty Traders

Establishments primarily engaged in investing in oil and gas royalties or leases, or fractional interest therein.

SIC 1321—Natural Gas Liquids Production

Establishments primarily engaged in producing liquid hydrocarbons from oil and gas field gases.

SIC 1623—Pipe Line Construction

—Distribution lines (oil and gas field construction)
—Pipe laying
—Pipe line construction
—Pipe line wrapping
—Pumping station construction

SIC 1629—Heavy Construction

—Oil refinery construction
—Petroleum refinery construction

SIC 3494—Valves and Pipe Fittings

SIC 3498—Fabricated Pipe and Fabricated Pipe Fittings

SIC 3559—Special Industry Machinery

—Petroleum refinery equipment

SIC 4226—Special Warehousing and Storage

—Oil and gasoline storage caverns (for hire)
—Petroleum and chemical bulk stations and terminals for hire

SIC 4925—Mixed, Manufactured or Liquefied Petroleum Gas Production and/or Distribution

Establishments engaged in the manufacture and/or distribution of gas for sale, including mixtures of manufactured with natural gas.

SIC 5084—Industrial Machinery and Equipment

—Derricks (Wholesale)
—Drilling bits (Wholesale)
—Oil Refining machinery, equipment and supplies (Wholesale)
—Oil well machinery, equipment, and supplies (Wholesale)
—Oil well supply houses (Wholesale)

SIC 5171—Petroleum Bulk Stations and Terminals

Establishments primarily engaged in wholesaling petroleum products, including liquefied petroleum gas, from bulk liquid storage facilities.

SIC 5172—Petroleum and Petroleum Products Wholesalers

Establishments primarily engaged in wholesaling petroleum and products. Included are packaged and bottled petroleum products distributors, truck jobbers, and other marketing petroleum and products at wholesale.

SIC 6211—Security Brokers, Dealers and Flotation Companies

—Oil and gas lease brokers
—Dealers in oil royalties

SIC 8911—Engineering, Architectural and Surveying Services

—Petroleum Engineering

Others

Establishments and individuals engaged primarily in oil and gas related activities. Examples of such loans would be mortgages and personnel loans to individuals whose sole source of repayment is from the profits of an oil or gas company or employment by an oil or gas company.

Exhibit B—General Lending Limitation Calculations

(For use until January 1, 1988)

Calculation date ____________

1. Total capital on December 31, 1985 ——
2. 15% of the amount on Line 1 ——
3. Total capital on calculation date ——
4. 15% of the amount on Line 3 ——

IF THE AMOUNT ON LINE 4 EQUALS OR EXCEEDS THE AMOUNT ON LINE 2, STOP HERE. THE BANK'S CURRENT GENERAL LENDING LIMITATION IS THE AMOUNT ON LINE 4.

5. Sum of Special Category Loan Charge-offs since December 31, 1985 (but only through December 31, 1987). ——
6. Sum of all recoveries since December 31, 1985 on all loans included in Line 5. ——
7. Amount on Line 5 minus amount on Line 6 ——
8. Amount on Line 3 plus amount on Line 7 ——
9. 15% of the amount on Line 8 ——
10. 20% of the amount on Line 3 ——
11. Lesser of the amounts on Line 9 and Line 10 ——
12. Lesser of the amounts on Line 2 and Line 11 ——

THE BANK'S CURRENT GENERAL LENDING LIMITATION IS THE AMOUNT ON LINE 12.

[FR Doc. 86-9058 Filed 4-22-86; 8:45 am]

BILLING CODE 4810-33-M

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Airspace Docket No. 86-AGL-4]

Establishment of Transition Area; Paxton, IL

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: The nature of this action is to establish the Paxton, Illinois transition area to accommodate a new VOR Runway 18 instrument approach procedure to Paxton Airport.

The intended effect of this action is to ensure segregation of the aircraft using approach procedures in instrument conditions from other aircraft operating under visual weather conditions in controlled airspace.

EFFECTIVE DATE: 0901 U.T.C., July 3, 1986.

FOR FURTHER INFORMATION CONTACT: Edward R. Heaps, Air Traffic Division, Airspace Branch, AGL-520, Federal Aviation Administration, 2300 East Devon Avenue, Des Plaines, Illinois 60018, telephone (312) 694-7360.

U.S. LEAGUE OF SAVINGS INSTITUTIONS
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PREFACE

This report proposes a two-part program for easing the pressures on the Federal Savings and Loan insurance Corporation. While it addresses the agency's funding problem, it also places great emphasis on a series of initiatives aimed at the special problems of institutions located in economically depressed areas.

Calls for the injection of funds into the FSLIC have dominated the legislative agenda of the congressional banking committees for the past two years. Yet despite the many hundreds of hours of debate on the subject, it is still not possible to define the dimensions of the problem with any degree of precision. The plain and simple fact is that nobody really knows in dollar terms what the costs of the problems of the FSLIC will be.

Consequently one of our goals was to help set up a flexible program that can be adapted to meet whatever future financial demands are placed on the FSLIC and the federal deposit insurance systems in general. The program developed by the League substantially meets the funding objectives of the plan advocated by the Treasury Department and the Federal Home Loan Bank Board last year.

But also of great importance, it is becoming clear that any program for dealing with federal deposit insurance today must recognize the existence of what might be called areas of regional depression in the United States. These regions begin in the energy belt, extend to the farm belt and touch on states with economies depending on forest products, mining and other industries.

As some of the exhibits in this report show, there is obviously a pattern here, and the FSLIC's problems are heavily concentrated in these depressed areas. This report is also intended to contribute to a broader recognition in Congress and among the public generally of the need to take special measures to ease the great economic strains in these areas.

Consequently, rather than simply focusing on funding, our program recommends a number of regulatory, supervisory and accounting initiatives aimed at dealing with the special problems of institutions in these seriously depressed localities.

As this report also demonstrates, the commercial banking regulators are already taking this kind of approach in depressed states and regions. As will be seen, our program borrows heavily from what the commercial banking regulators are already doing.

We believe that if we can buy time through this program and preserve many well-managed institutions now in trouble simply because of local economic conditions beyond anyone's control, the communities these institutions serve will be better for it and the burden on the FSLIC's insurance fund will be that much less.

EXECUTIVE SUMMARY

Much has changed since the first formal proposals to provide additional new funds for the FSLIC were made in early 1986. Most notably, it has become clear that economic conditions in the nation vary significantly by state and even local communities. As a result, some key assumptions underlying the several FSLIC refunding proposals advanced in 1986 are no longer valid.

(These early plans included one proposed by the U.S. League in March, 1986; one proposed at approximately the same time by the Treasury and the Federal Home Loan Bank Board, and an alternative "Pay-As-You-Go" plan proposed by the U.S. League later in 1986.)

Originally, it was assumed that there was a limited, one-time bulge in the FSLIC's case load that had to be dealt with on an extraordinary basis over the next few years. But as the U.S. League's reactivated Task Force on FSLIC Issues reviewed the situation facing the FSLIC as 1986 drew to a close, it found that this was not the case. Instead, it found that the deepening economic depressions in various states are creating major difficulties for both savings institutions and commercial banks in those areas. In fact, many states could see their financial institution infrastructure dissolve unless special provisions are made.

Many well-managed institutions are being overwhelmed by local economic conditions which resemble those of the 1930s. The severity of the situation is emphasized by the fact that problems are no longer confined to commercial real estate problems -- large numbers of traditional single-family loans are now turning up in the non-performing categories in some areas.

Thus, the capital of many institutions in these areas is now being eroded by operating losses from the lack of earnings on non-performing assets. These problems are being compounded by the use of the powerful provisions of the classification of assets regulation which when combined with the depressed local economic environment means that many well-run institutions can be written into insolvency.

The Task Force believes this new situation requires a new approach to resolving the FSLIC's problems, and that our two-pronged "Savings Institutions Self-Help Plan" is the kind of new approach that should be taken.

First, we believe the Federal Home Loan Bank Board should adopt a forbearance policy toward the difficulties of well managed institutions located in economic disaster areas. This is similar to the approach already being used in the commercial banking business.

Second, we believe the FSLIC should be provided with additional funds under a blending approach that combines parts of the U.S. League's 1986 "Pay-As-You-Go" Plan and the Treasury/Bank Board Recapitalization Plan also proposed last year.

PART 1 -- FORBEARANCE FOR INSTITUTIONS IN DEPRESSED AREAS

As detailed in the body of this report and in Appendix A, there is ample precedent for the "two-tiered" approach to the regulation and supervision of savings institutions recommended in this program. A number of steps were taken to buy time early in this decade when the majority of savings institutions were suffering losses because of savings-rate deregulation and high interest rates, and in 1986 Congress legislated regulatory accounting provisions for the Farm Credit System.

Of particular significance, in 1986 the three federal commercial bank regulatory agencies embarked upon a program of supervisory forbearance toward well-managed commercial banks located in areas that depend heavily on agriculture or energy. Banks were encouraged to work with troubled energy borrowers. The regulators established a capital forbearance policy, relaxed lending limits, and encouraged the use of the provisions of generally accepted accounting principles that allow them, in certain circumstances, to continue carrying low paying or non-paying loans on their books without having to write them down.

Like the forbearance policy for commercial banks, the U.S. League's program also offers this kind of "breathing space" for well-managed savings institutions, and will ease potential future burdens on the FSLIC.

Specifically, the Task Force recommends that the Federal Home Loan Bank Board take the following three actions:

1. Issue a policy statement directing the Principal Supervisory Agents (PSAs) to exercise forbearance in handling well-managed institutions in trouble due to local economic conditions.

2. Consistent with the commercial bank regulators' joint statement, the Federal Home Loan Bank Board should require savings institutions to account for problem assets according to GAAP.

   To facilitate this recommendation, the Bank Board should revise a number of its regulations:

   - The asset classification regulation should use valuation standards consistent with GAAP in establishing the carrying value of assets.
   - Appraisal Memorandum R41c should be rescinded immediately and its predecessor, Memorandum R41b, should be accepted instead as an interim measure pending study of an appraisal standard for the business. As Memorandum R41b is used to determine asset carrying values for existing assets in the interim, the Bank Board should use a discounting technique which is consistent with GAAP.
   - Confine its use of the scheduled item approach to single family and two- to four-family residential mortgages. Also, the residual value after any write-down of income producing repossessed one- to four-family properties would not be subject to the additional 20 percent capital requirement.

Together, this package of regulatory and supervisory actions will make it possible for many well-managed savings institutions in economically depressed areas to survive and continue serving their local communities. Even though the economic dislocations in some of these areas are great and will require major restructuring on the local level, well-managed institutions adapting to these changes with sound and realistic business plans must be given the opportunity to survive.

This policy will also help forestall the need for the FSLIC to take over the assets of many of these institutions and dispose of them at unrealistically low, "fire-sale" levels, which would be inevitable because these institutions are concentrated in regions already mired in economic depression. In turn this would further depress local real estate values, compounding problems for remaining insured depository institutions and making the depression worse.

The policy statement (Recommendation #1) is of particular importance. In addition to formally articulating a policy of forbearance, it should direct PSAs to consult with state savings institution commissioners in granting forbearance and allow PSAs to lower capital requirements for specific institutions. A statement of this kind would make it clear throughout the FHLB System that rules and regulations designed to curb unsound practices are not applied so indiscriminately that they worsen the problems of well-managed institutions in trouble merely because of general economic circumstances beyond their control.

The recommendation applying generally accepted accounting principles to the treatment of loans (Recommendation #2) would permit savings institutions to account for problem loans according to Statement of Financial Standards 15 (SFAS 15) just as commercial banks do. Also, it would alter the Bank Board's appraisal guidelines which require many well-run institutions to recognize excessively large losses on problem assets and to incur needless expense in having properties reappraised. (See Appendix B for a discussion of accounting methods.)

The third part of the recommendation would eliminate a problem that arises when, in assessing risk on a loan portfolio, certain non-traditional types of loans are subject both to the scheduled items approach and to the classification of assets system. This can result in a "double hit" to an institution where it must both add to its reserves if the asset is classified as doubtful and increase its net worth if the loan also becomes a scheduled item -- and of course there is a heavy concentration of problem loans in economically troubled areas.

PART 2 -- FUNDING FOR THE FSLIC

Despite dire predictions, the reality about the financial condition of the FSLIC is less grim. Although commentators have suggested that the fund would be down to $1 billion in resources by the end of 1986, on September 30, 1986, the agency had cash and government securities on hand of $4.6 billion.

Nevertheless, additional resources should be provided to the agency, and last year the U.S. League developed a funding proposal that would provide comparable resources to the FSLIC as one developed by the U.S. Treasury and the Federal Home Loan Bank Board. The difference in the two plans was a modest one of timing, with the funds being collected on a pay-as-you-go basis in the U.S. League's alternative.

The Treasury/Bank Board proposal would have required borrowing $10 to $15 billion "up front", burdening the business with huge interest payments for up to 20 years or more. The concern in the savings institution business was that these enormous "front-end" borrowings would mortgage its future. (For a discussion of the background of FSLIC recapitalization plans, see Appendix C.)

Critics of the U.S. League's approach charged that it did not provide enough resources to the FSLIC in the early years, and that if the FSLIC's problems proved larger than expected there was no way to provide more funds.

The U.S. League has re-examined its position with the goal of developing a solution to the FSLIC's funding needs that will be acceptable to all parties. The result is a blending of the "pay-as-you-go" approach with a modest bonding approach.

Specifically, the League has developed a three-part program for providing funds to the FSLIC:

RECOMMENDATION #1:

The Savings Institution Self-Help Program for funding the FSLIC. This funding proposal is explained below.

RECOMMENDATION #2:

Restore the legal framework governing the FSLIC's secondary reserve to its condition prior to the Garn St Germain act of 1982.

The Garn-St. Germain act included language in Section 126 permitting the secondary reserve to be used on the same basis as the primary reserve. Previously, the secondary reserve was to be tapped only to cover FSLIC losses and was to be used only to the extent other funds were unavailable -- restrictions flowing from the fact that the funds in the secondary reserve represent prepaid insurance premiums that were intended to be refunded over time.

These restrictions are needed to help convince the accounting profession that savings institutions should continue to carry their investment in the secondary reserve as an asset on their books. While the 1982 changes were justified under extreme conditions then existing, there is no need for their continuation in the context of the additional funds being provided to the FSLIC by the funding program.

RECOMMENDATION #3:

Extend the provisions of Section 597 and Section 368(a)(3)(D)(ii) of the tax code beyond their expiration date of January 1, 1989.

In dealing with the caseload of the FSLIC on the schedule common to both the Treasury/Bank Board and the U.S. League versions of an FSLIC recapitalization plan, it is important to recognize the necessity of retaining two provisions, enacted in 1981 as part of the tax code changes at that time, which reduce hard dollar FSLIC outlays in problem resolutions.

These tax code provisions are Section 597 and Section 368(a)(3)(D)(ii). The first extends tax-free status to FSLIC dollars expended to resolve a problem case and the second permits an acquirer of a problem case to use the shelter of the net operating loss carryforwards of the acquired institution. In the recently adopted revisions of the tax code, these two provisions were extended until January 1, 1989, but it is essential to extend them for at least a further three years, as originally recommended by the Treasury in the presidential tax package in May 1985, to ensure that new funds made available to the FSLIC can be used to maximum effect in case resolutions.

THE SAVINGS INSTITUTION SELF-HELP PROGRAM FOR FUNDING THE FSLIC

The Self-Help funding program would involve three steps:

1. If needed, the business would continue to pay the special insurance assessment, first levied at the beginning of 1985, on a six-year phase-down schedule. The assessment would drop to 83.33% in 1988, 66.67% in 1989, 50% in 1990, 33.33% in 1991, 16.67% in 1992 and 0% thereafter.

2. If needed, a funding corporation set up by the plan would be authorized to issue zero-coupon bonds. They would be repaid from the 20% of net income the Federal Home Loan Bank System currently sets aside in the "legal reserve", which is not available to pay dividends to member institutions.

3. With the savings institution business being potentially asked to contribute huge amounts of resources to the FSLIC, the Bank Board should be accountable for their use by the insurance fund. Therefore, an oversight committee with representatives from the business would be statutorally established, the Bank Board would be required to report periodically to Congress on the use of the funds and the authority to continue to raise funds via the funding corporation would be subject to annual Congressional scrutiny.

With respect to Step 1, it must be emphasized that over the past two years the nation's savings institutions have paid more than $2 billion in special FSLIC assessments over and above the regular insurance premiums. Because of the special premium, a savings institution pays at least two-and-one-half times as much in insurance premiums as an equivalent sized commercial bank. And in addition to the inequitable treatment, the special assessments are encouraging stronger savings institutions to migrate from the FSLIC system to that of the Federal Deposit Insurance Corporation.

If the FSLIC's cash resources fall below some specified level, the funding corporation proposed in Step 2 would have authority to raise up to $2.5 billion in zero-coupon borrowings in the program's first year and another $2.5 billion in the second year (See Appendix B for details). If the Bank System's earnings do not grow quickly enough, it is possible the 20% of net income might not be sufficient to retire the principal and accrued interest on the bonds. In that case, the difference would be made up by assessments on the business.

The phased-down special assessment is estimated to provide the FSLIC with an additional $4.6 billion between 1987 and 1992. (This assumes that the business' deposits continue to grow at their estimated 1986 rate of 6 percent per year.) Combined with the FSLIC's regular premium income, this would provide the FSLIC with a total cash flow of $20 billion over the next 10 years.

Consequently, the industry's Self-Help Plan would give the FSLIC virtually the same funding, if events so warrant, as that provided by the Treasury/Bank Board Plan, as shown in the following table:

FSLIC CASH FLOW FROM EXTERNAL SOURCES UNDER INDUSTRY SELF-HELP PROGRAM AND TREASURY/BANK BOARD PLAN

Cash Flow Over:	U.S. League Savings Insts. Self-Help Program	Treasury/Bank Board Program	
		$10 Billion in Borrowings	$15 Billion In Borrowings
2 Years	$ 8.9 Billion	$ 8.7 Billion	$ 9.6 Billion
5 Years	$13.8 Billion	$16.8 Billion	$21.4 Billion
10 Years	$20.0 Billion	$19.0 Billion	$21.6 Billion
20 Years	$38.7 Billion	$29.7 Billion	$28.3 Billion

The sources of this cash flow are shown in the table on the following page and in more detail in Exhibit 1 at the end of this report.

Over the next two years, the League alternative will provide $200 million more to the FSLIC than the Treasury/Bank Board plan if $10 billion were borrowed in the latter. Even if $15 billion were borrowed instead of $10 billion, the League's plan would provide only $700 million less over the next two years.

Over the long haul, the FSLIC fares much better in the League's proposal since it is not burdened with the heavy debt service of the Administration plan. Only when one looks at a five-year time-horizon does the FSLIC fare better in the Treasury/Bank Board plan.

However, the League's position is that, because of the uncertainty as to the size of the problem, a program should be put in place to cover the next two years rather than having a five- or six-year program which burdens the system with heavy interest payments into the next century.

After two years, if the situation remains critical, the Congress should have the opportunity to revisit the question and, since the Self-Help program does not touch the current retained earnings of the Federal Home Loan Bank System, there is enough flexibility to be able to provide more resources at that time if Congress so directs.

The advantages of the U.S. League's new self-help program include the following:

- It will provide the FSLIC with $8.9 billion over the next two years. With its other resources, this will give the FSLIC an inflow of funds over the next two years of $10 billion or more, or an average of $5 billion a year. This is $1.5 billion more in expenditures than the record level of fiscal 1986.

- It is a flexible plan, and does not consider touching the $2.2 billion the Federal Home Loan Bank System currently holds in retained earnings.

SOURCES OF FSLIC EXTERNAL CASH FLOW UNDER ALTERNATIVE PROPOSALS

	U.S. League Savings Insts. Self-Help Plan	Treasury/ Bank Board $10 B.	Treasury/ Bank Board $15 B.
TWO-YEAR CASH FLOW:			
Regular Premiums	$1.6 B.	$1.6 B.	$1.6 B.
Special Assessments	$2.2 B.	$2.2 B.	$2.2 B.
Borrowings	$5.0 B.	$5.0 B.	$6.0 B.
Subtotal	$8.9 B.	$8.9 B.	$9.9 B.
less			
Interest on Debt	$0.0 B.	$0.2 B.*	$0.2 B.*
TOTAL	$8.9 B.	$8.7 B.	$9.6 B.
FIVE-YEAR CASH FLOW:			
Regular Premiums	$4.5 B.	$4.5 B.	$4.5 B.
Special Assessments	$4.3 B.	$4.3 B.	$4.3 B.
Borrowings	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$13.8 B.	$18.8 B.	$23.8 B.
less			
Interest on Debt	$0.0 B.	$2.0 B.*	$2.4 B.*
TOTAL	$13.8 B.	$16.8 B.	$21.4 B.
TEN-YEAR CASH FLOW:			
Regular Premiums	$10.4 B.	$10.4 B.	$10.4 B.
Special Assessments	$4.6 B.	$4.6 B.	$4.6 B.
Borrowings	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$20.0 B.	$25.0 B.	$30.0 B.
less			
Interest on Debt	$0.0 B.	$6.0 B.*	$8.4 B.*
TOTAL	$20.0 B.	$19.0 B.	$21.6 B.
TWENTY-YEAR CASH FLOW:			
Regular Premiums	$29.1 B.	$29.1 B.	$29.1 B.
Special Assessments	$4.6 B.	$4.6 B.	$4.6 B.
Borrowings	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$38.7 B.	$43.7 B.	$48.7 B.
less			
Interest on Debt	$0.0 B.	$14.0 B.*	$20.4 B.*
TOTAL	$38.7 B.	$29.7 B.	$28.3 B.

*** Under the final version of the Treasury/Bank Board plan, the FSLIC does not actually pay the interest on the borrowings. Instead, the interest on the borrowings represent a first call on the premiums and/or assessments from the business. However, the interest payments are broken out as a separate obligation of the FSLIC in this table for the sake of clarity -- the net effect is the same. Under the League's self-help plan the Bank System (and perhaps the business) pays the interest.**

- Over the next 20 years, it is far cheaper than the Treasury/Bank Board proposal.

The question has been raised as to whether there is a cost to the FSLIC in delaying action in the final resolution of problem cases. But as detailed in Appendix D, the Bank Board has many ways of assuring that institutions under its control do not continue to increase risks to the deposit insurance fund.

These include replacing managements and boards of directors, or putting institutions in the Management Consignment Program. Certainly all responsible savings institutions, already burdened with billions of dollars in special insurance assessments, will demand that the Board ensure that other institutions are not allowed to continue to act in a manner likely to cost the industry even more money. And assets taken over by the FSLIC can be conserved through the Federal Asset Disposition Corporation.

In fact too rapid an approach to the disposition of problem assets can actually be expensive for the FSLIC. As noted earlier, with problem assets concentrated in a few states and regions, notably those already in deep economic trouble, the assets would have to be disposed of at fire-sale prices. In turn, this would further erode local real estate values generally, creating problems for all financial institutions in the area and making the depression worse.

The situation is much like that early in this decade. According to calculations by the Government Accounting Office, by taking an essentially wait-and-see attitude the FSLIC saved itself approximately $4.7 billion, which almost precisely equals the $4.6 billion in cash and securities the FSLIC had on hand at the end of September, 1986. Were it not for these savings, the FSLIC would now be totally out of money. (See Appendix A.)

I. FORBEARANCE FOR INSTITUTIONS IN DEPRESSED AREAS

Effects of the tremors that have rocked the American financial system over the past 10 years continue to be felt. First came historical extremes in inflation and in the level and volatility of interest rates. These are natural enemies of all financial institutions -- and especially of long-term lenders.

The federal government's solution for financial institutions was to deregulate interest rates on deposits. But while deregulation was designed to strengthen the system ultimately, it was implemented at the expense of eliminating or severely weakening institutions which were not prepared to survive the transition.

Deregulation also brought with it the temptation for some financial institution managers to take new and greater risks than traditionally deemed prudent for such lenders. Some particularly risky strategies assumed that the inflation which caused so much trouble would become a permanent fixture of the economy. Problems stemming one way or another from inflation (and subsequent deflation) and high interest rates are generally blamed for the difficulties now facing the agencies that provide federal deposit insurance.

However, far less attention has been directed at another perplexing phenomenon with a great impact on financial institutions: The growth, and now the coexistence, of two separate and decidedly unequal economies in the United States.

On the one hand, the economy as a whole has entered the fifth year of a relatively stable recovery from the severe recession of 1982, one of the longest recoveries on record. While a recession or at least a pause in the recovery could occur at any time, the economy is generally strong, and some of its most serious problems now appear resolved. Inflation has been brought under control. Interest rates have subsided and seem likely to remain low for the immediate future, and some regions, notably the Northeast, are thriving.

Similarly, by most measures the savings institutions business as a whole is performing better than ever. Earnings, interest rate spreads, lending volume and other indicators are at or above historic highs at the vast majority of institutions. A business that some were predicting just a few years ago would fade away or be absorbed into more general purpose types of financial institutions, such as commercial banks, has turned itself around. Along with producing these gratifying results, most savings institutions have made impressive progress in reducing their exposure to the interest rate risk that caused them such problems early in the decade.

The generally favorable picture for the economy and the savings institutions business is marred, however, in that both are seriously depressed in some parts of the country.

Sharp downturns in certain industries have hit some cities, regions and states so hard that financial institutions serving those areas are under extraordinary strains. Bad weather, weak demand for American food exports, poorly timed changes in world and U.S. agricultural policies and depressed food prices have contributed to one of the worst periods for farmers in American history.

The world oversupply of oil and gas and the resultant fall in prices of all fossil fuels have turned the booming oil and gas producing states -- and less prosperous coal dependent regions -- into economic wastelands. Overseas competition in the production of minerals, timber, steel and other materials have hit those industries hard. Exhibit 2 shows the 18 states currently experiencing the greatest economic hardships as measured by unemployment, personal income and housing starts.

Assigning responsibility for these dislocations is not the subject of this report. It is sufficient to note that the affected financial institutions themselves did not bring about the economic distress plaguing them and their areas.

Among financial institutions, commercial banks are hit first and hardest when the industry an area relies on suffers a downturn. As Exhibit 3 shows, two states, Texas and Oklahoma, account for more than one-fourth of the commercial banks closed by regulators in the past two years. Another 40 percent of the closings in those two years occurred in the 10 states that constitute the Midwestern farm belt. As is shown in the map in Exhibit 4, energy- and agriculture-dominated states in other parts of the country also have large numbers of closings.

It is easy to see why the commercial banking industry's fate in a given region closely parallels that of the economy as a whole. Bank credit continues to be the lifeblood of small and medium enterprises such as many farms and energy producers. If a grain farmer is unable to recover the production costs because of low food prices, the bank from which he borrowed for seed, fertilizer and equipment loses too. The harvest that was collateral is likely to be worth far less than the loan balance.

But if banks are the first to suffer, the next wave of trouble engulfs lenders who hold mortgages. As farm operations sour, people in the service and manufacturing businesses that support agriculture lose their jobs, other parts of the region's economy suffer, and eventually the quality of mortgage debt and loans for other household purposes declines along with business debt.

The impact of economic distress on savings institutions is graphically portrayed in the maps in Exhibit 5, which highlight states where savings institutions, on the average, had poor operating results in the first half of 1986. These maps overlap closely the previous ones showing general economic stress and commercial bank difficulties in various states, suggesting that most problems in these states are systematic.

Whatever criteria are used to define areas where financial institutions are having difficulties because of local economic problems, it is clear there is at least some causal relationship. In areas heavily dependent on certain currently depressed industries, financial institutions are experiencing far more trouble than those located elsewhere or the average institutions nationwide.

Recognizing the emergence of this "two tiered" economy, the U.S. League has drawn up a series of recommendations to diminish the imminent pressures on the Federal Savings and Loan Insurance Corporation while buying additional time for savings institutions in economically depressed regions to recover from the temporary adversity facing them.

There is ample precedent for this approach in past situations involving savings institutions and, especially, commercial banks.

Early in this decade, when the majority of savings institutions were suffering losses because of savings-rate deregulation and high interest rates, a number of steps were taken to buy time. Congress authorized the Net Worth Certificate program and the regulators allowed many institutions to operate below minimum capital standards.

Responding to the growing crisis in the agricultural sector, in 1986 Congress legislated regulatory accounting provisions for the Farm Credit System.

Even more significantly, in the same year the federal commercial bank regulators adopted a program of supervisory forbearance to assist "basically sound, well-managed banks to weather this transitional period" of economic hardship in parts of the country dominated by the agriculture and timber, energy production and mining industries. (A description of the commercial bank regulators' forbearance plan and of other relevant forbearance models is given in Appendix A to this report).

In an implementing statement, the Comptroller of the Currency declared that the program's elements included encouraging banks to work with troubled agricultural and oil and gas borrowers, establishing a capital forbearance policy, relaxing lending limits, and encouraging "the use of generally accepted accounting principles which may permit loan restructurings without loss recognition."

The Comptroller's statement formally acknowledged that "capital should be used during periods of unusually heavy loan losses and that capital replenishment takes time." It specified that the OCC would not take administrative action to enforce minimum capital requirements where the bank is an agricultural or oil and gas lender, and its weakened capital position is due to problems in those sectors of the economy. Affected banks were also given permission, in certain circumstances, to continue carrying slow paying or non-paying loans without recognizing them as losses.

The actions recommended in the U.S. League's program would offer the same kind of "breathing space" as the forbearance policies of the commercial bank regulators adopted in early 1986.

At the same time, these steps would alleviate or possibly eliminate some potential future burdens on the FSLIC. There is challenge enough in marshalling the funds needed to pay for the merging or closing of institutions which are already insolvent. A funding proposal for that purpose is presented later in this report. It does not make sense to add to that burden soundly managed institutions which are temporarily unable to maintain the regulatory standards of good health because of regional or other factors beyond their control.

In promulgating the commercial bank forbearance rules, regulatory officials argued in 1986 that allowing extra workout time for institutions affected by downturns in the farm and energy sectors of the economy would pay off for everyone because these problems are temporary. Given enough time, these officials reasoned, the assets then performing poorly would recover their value at some point within a few years. Writing off those loans and foreclosing on the farmers and oil and gas producers now could conversely result in vast and unnecessary losses for the banks and their insurance agency as well as for borrowers. This reasoning is as valid now as it was then.

Moreover, the commercial banks addressed in the federal regulators' forbearance policy typically hold as collateral for their loans the farmers' harvests or oil and gas produced or equipment used by the borrowing firms. These commodities can fluctuate widely in value, depending on weather conditions, world markets and other factors difficult to predict.

On the other hand, loan portfolios of savings institutions are typically secured by land and houses. If real estate markets turn down, the value of the loan collateral can drop off -- in some cases, substantially. But some marketable value will always remain. And, given time, the value will likely swing back to or beyond its former level.

If there is a public policy justification for stretching out to seven years the time available to prudently managed commercial banks to work through loss-plagued portfolios of farm and oil and gas loans, it stands to reason that the case for extending a time-buying option to residential mortgage lenders is all the more compelling.

As noted previously, in 14 states, the savings institutions posted losses, on the average, in the first half of 1986. The asset classification regulation makes these difficulties even more severe. The combination of this regulation and a depressed local economy means that the regulators can, in effect, force almost any institution located in an area undergoing economic difficulties into insolvency.

One has to question whether placing otherwise soundly and conservatively run institutions in this situation is in the long-term interest of anyone, including the FSLIC insurance fund -- particularly when the insurance fund is limited in the amount of problem cases it can handle in any given time.

Therefore, as well as developing a funding strategy for the FSLIC, the U.S. League is recommending measures to allow institutions in troubled economic areas the opportunity to work through their problems. This plan is larger than just a financial solution for the FSLIC. It combines FSLIC funding measures with a work-out program to preserve as many honestly run institutions in troubled sections of the country as possible.

Specifically the League recommends the following:

RECOMMENDATION #1:

> The Federal Home Loan Bank Board should issue a policy statement to the Principal Supervisory Agents (PSAs) directing them to exercise forbearance from net worth requirements in handling well-managed institutions that find themselves in trouble due to local economic conditions.
>
> In judging if an institution is well-managed, the PSA should determine whether or not there is evidence of self-dealing, fraud, willful violations of laws and regulations, excessive growth or other irresponsible actions on the part of the institution's management, ownership or board of directors.
>
> The forbearance policy statement should mirror the joint policy statement issued by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

The policy statement should direct the PSAs to consult with state savings institution commissioners in granting forbearance. Involving the PSAs and the state commissioners is completely consistent with the Bank Board's moving its examination personnel from Washington to the twelve regional Federal Home Loan Banks since such delegated handling of the problem can be much more effective than a centralized system from Washington.

The policy statement would allow the PSA to lower the capital requirement for specific institutions. One way to structure such a program is that the PSA would declare a specific area to be economically depressed. Institutions holding investments in these areas which they were required to write down could apply for a capital requirement reduction. If an amount of the loss reserve that was required was judged to be a result of depressed local economic conditions, that identified amount would be subtracted from the institution's required capital level.

The benefit of such a program is that it would allow some leeway for financial difficulties due to causes outside management's control while maintaining the regulator's ability to judge the condition of an institution. The Comptroller of the Currency also pointed out this advantage to its forbearance program:

> "...the policy retains existing financial presentation and creates no inconsistencies with generally accepted accounting principles. The OCC believes that maintaining the integrity of financial statements is vital to assuring confidence in the banking system." [Federal Register, Vol. 51, No. 78, p. 15307]

RECOMMENDATION #2:

Consistent with the commercial bank regulators' joint statement, the Federal Home Loan Bank Board should require savings institutions to account for problem assets according to GAAP.

To facilitate this recommendation, the Bank Board should revise a number of its regulations:

- The asset classification regulation should use valuation standards consistent with GAAP in establishing the carrying value of assets.
- Appraisal Memorandum R41c should be rescinded immediately and its predecessor, Memorandum R41b, should be accepted instead as an interim measure pending study of an appraisal standard for the business. As Memorandum R41b is used to determine asset carrying values for existing assets in the interim, the Bank Board should use a discounting technique which is consistent with GAAP.
- Confine its use of the scheduled item approach to single family and two- to four-family residential mortgages since it is superflous for application to assets subject to the asset classification regulation. Also, the residual value after any write-down of income producing repossessed one- to four-family properties would not be subject to the additional 20 percent capital requirenment.

In the accounting area of most immediate and important concern to savings institutions today -- the accounting for problem loans and other problem assets -- regulatory accounting procedures call for far more rigorous treatment than does GAAP. Indeed, many savings institution managers have noted that, in the accounting sphere, they are facing the worst of all possible worlds.

Where regulatory accounting practices are more lenient than GAAP, public auditors apply GAAP standards. But where regulatory accounting procedures are tougher than GAAP, as in the problem asset area, public auditors and professional appraisers adopt the regulatory practices because they fear lawsuits by the FSLIC should the institution wind up as an FSLIC problem case. And in spite of all of this, the business is accused by the media and by politicians of lax accounting practices.

Under GAAP, a loan receivable is carried at the lesser of cost or 1) net realizable value, or 2) a carrying value determined in accordance with the provisions of SFAS 15 relating to troubled debt restructuring where the property is original obligor remains in place. The difference between these GAAP valuation methods and that required under regulatory accounting practices are outlined in detail in Appendix B.

The valuing on the basis of net realizable value results in the institution discounting future net cash flows from the sales and net revenues associated with the property at the institution's cost of money. Since the institution's cost of funds will almost always be lower than the discount rate used by an appraiser in appraising a property on the basis of R41c, the asset's regulatory carrying value will be reduced to a level below the carrying value required under generally accepted accounting principles.

As the detailed example on pages 34 and 35 in Appendix B clearly shows, the net effect over the term of the loan of each of the accounting methods is the same. What is eliminated in the methods allowed under GAAP is the upfront hit to income and net worth which occurs under regulatory accounting requirements. Under GAAP, the loss is spread more evenly and the institution's books reflect asset carrying values in a manner consistent with the practice at commercial banks and other business organizations.

The example also shows how the continuation of regulatory asset valuation techniques can significantly exacerbate the short term deterioration of the FSLIC by overstating losses when problems are recognized. Later, when the asset is sold and the debt repaid, perhaps too late for the institution involved, the FSLIC will record a gain which will bolster its reserves.

The third part of the recommendation asks that the Bank Board confine its use of the scheduled item approach to single family and two- to four-family residential mortgages since it is superflous for application to assets subject to the asset classification regulation.

Until the adoption of the classification of assets regulation in January 1986, the Bank Board had used the so-called scheduled items system to assess risk in an institution's lending portfolio. Loans in a delinquent status were included as scheduled items and each institution was required to increase its net worth by 20 percent of such items.

With the lending powers of savings institutions becoming more diverse, the Bank Board judged the scheduled items approach to be no longer adequate for assessing the risk of loans other than those on one- to four-family properties. One of the reasons for the inadequacy of the old approach was that it relied on timeliness of payments as a barometer of loan quality. However, many acquisition, development and construction loans, for example, were often characterized by having an interest reserve which prevented the loan from reaching delinquent status for, perhaps, a prolonged period of time.

Instead of a scheduled items approach, the Bank Board adopted the classification of assets system for such loans. This regulation provides for the classification of certain problem loans as substandard, doubtful or loss.

An institution is required to recognize a loss and to establish specific reserves against assets classified as loss or doubtful. The required reserves are 100 percent of the loan amount for a loss classification and 50 percent (later clarified to be a variable reserve of between 1 percent and 50 percent) for a doubtful classification. An asset classified substandard will be treated just as scheduled items have been treated in the past, requiring an increase in net worth of 20 percent of the substandard item.

The problem arises where the classification of assets regulation and a scheduled item approach are both applied to the same asset. For instance, suppose that an asset was judged to fall in the doubtful category and the institution was required to book a 50 percent loss and to post a 50 percent specific reserve. The remaining 50 percent is presumably recoverable but could still be judged to be a scheduled item requiring an additional increase in net worth of 20 percent of this recoverable amount.

Applying the scheduled item approach only to one- to four-family loans and using only the classification of assets approach for more non-traditional lending would eliminate this double hit. Doing so would make sense since the Bank Board itself judged that the scheduled item approach was no longer appropriate for the latter form of lending.

In proposing this program, the League in no way encourages any slackening in the vigilance of the regulatory authorities to ensure that high-flying institutions do not expose the FSLIC to more risk of loss. It is enough of a burden to ask savings institutions to provide resources for the FSLIC to handle its existing caseload without being also asked to pay for new problems that could be avoided through effective supervision.

II: A FUNDING PROPOSAL FOR THE FSLIC

Over the last year and more, there have been dire predictions about the financial condition of the FSLIC. Commentators have suggested that the fund would be down to $1 billion in usable resources by the end of 1986. The reality is less grim. True; reserves declined by $3.9 billion, from $7.5 billion at the end of fiscal 1985 to $3.6 billion at the end of fiscal 1986. However, as Exhibit 6 shows, the FSLIC had cash and government securities on hand of $4.6 billion at the end of September, 1986. During fiscal 1986, this figure declined by $1.1 billion. Because the FSLIC had income of $2.4 billion, this means it expended $3.5 billion during the fiscal year.

During the same fiscal year, the insurance fund showed an operating loss of $3.9 billion. But this was more than explained by $5.9 billion in accounting loss provisions.

Nonetheless, given the problems facing the FSLIC, the U.S. League concedes that additional resources should be provided for the fund. Last year, the League developed a plan to provide the FSLIC with the funds to handle its problems. This plan would make the same resources available to the FSLIC for problem resolution over the next eight years as provided in the recapitalization proposal developed by the U.S. Treasury and the Federal Home Loan Bank Board. The main difference in the two plans was one of timing.

The major benefit of the League's proposal was that it would eliminate the need to borrow the $10 to $15 billion envisioned in the Treasury/Bank Board proposal. These borrowings would have burdened the business with huge interest payments for up to 20 or more years. In the U.S. League's alternative, the funds needed would be collected on a pay-as-you-go basis while still allowing the FSLIC to resolve cases in far greater volume than it has in the past.

The borrowing approach of the Administration proposal was of concern to others besides the savings institution business. The Congressional Budget Office placed a major roadblock in the proposal's way when it ruled last July that the borrowings could not be scored as receipts by the government for budget purposes and, as a result, spending the proceeds in resolving cases would add to the federal budget deficit.

Technical changes in the proposal resulted in a change of position by the CBO. However, the CBO labeled its acceptance of the revised plan as "technical" and a "close call". The Chairman of the House Banking Committee called the plan "all smoke and mirrors".

In spite of the CBO's reluctant change of heart, the plan was by its nature one of deficit spending. Federal budget deficits have been a cancer on the American economy for the last decade. The philosophy has been one of spend now and pay later. Similarly, the Treasury/Bank Board plan called for pushing the cost of current case resolution into the future, even into the next generation.

Over the last several years, the U.S. League's highest political objective has been to persuade the Congress and the Administration to get the federal budget deficit under control. It should be no surprise that the League feels uncomfortable about the borrowings in the Administration proposal, and would advance a "pay-as-you-go" approach instead.

In its proposal, the savings institution business took a unique step. It did not seek the appropriation of taxpayer money to solve its problems. Instead, it agreed to use the resources of essentially its strong components to resolve problems that they did not have a hand in creating.

There were two main criticisms of the League's pay-as-you-go approach. First, critics charged that the proposal did not provide enough resources to the FSLIC in the early years to handle its most immediate problems. It was asserted that it would be more expensive in the long run not to provide the FSLIC with huge amounts of funds up front since problem cases would continue to fester and become more expensive to resolve if they were not conclusively dealt with in an expeditious fashion. This contention is dealt with in Appendix D.

Second, it was charged that if the FSLIC's problems proved larger than expected, there was no way in which even more funds could be provided.

In an attempt to answer these criticisms, the U.S. League has re-examined its position to see if there is any way to meld its prior proposal with that of the Treasury/Bank Board to develop a solution for the funding needs of the FSLIC that all parties would accept.

The result is a fusing of the "pay-as-you-go" approach with a modest bonding approach. To accurately reflect who is footing the bill in this plan, as indeed in the other plans, we have called this the "Savings Institution Self-Help Plan for Funding the FSLIC."

In particular, the Task Force proposed the following three recommendations as a legislative program for funding the FSLIC:

Recommendation #1:

A three-part program for providing resources to the FSLIC that substantially meets the funding objectives of the plan advocated by the Treasury/Bank Board plan. This program is outlined in detail later in the report.

Recommendation #2:

Restore the legal framework governing the FSLIC's secondary reserve to its condition prior to the Garn St Germain act of 1982.

The Garn-St. Germain act included language in Section 126 permitting the secondary reserve to be used on the same basis as the primary reserve. Previously, the secondary reserve was to be tapped only to cover FSLIC losses and was to be used only to the extent other funds were unavailable -- restrictions flowing from the fact that the funds in the secondary reserve represent prepaid insurance premiums that were intended to be refunded over time.

These restrictions are needed to help convince the accounting profession that savings institutions should continue to carry their investment in the secondary reserve as an asset on their books. While the 1982 changes were justified under extreme conditions then existing, there is no need for their continuation in the context of the additional funds being provided to the FSLIC by the funding program.

Recommendation #3:

Extend the provisions of Section 597 and Section 368(a)(3)(D)(ii) of the tax code beyond their expiration date of January 1, 1989.

In dealing with the caseload of the FSLIC on the schedule common to both the Treasury/Bank Board and the U.S. League versions of an FSLIC recapitalization plan, it is important to recognize the necessity of retaining two provisions, enacted in 1981 as part of the tax code changes at that time, which reduce hard dollar FSLIC outlays in problem resolutions.

These tax code provisions are Section 597 and Section 368(a)(3)(D)(ii). The first extends tax-free status to FSLIC dollars expended to resolve a problem case and the second permits an acquirer of a problem case to use the shelter of the net operating loss carryforwards of the acquired institution. In the recently adopted revisions of the tax code, these two provisions were extended until January 1, 1989, but it is essential to extend them for at least a further three years, as originally recommended by the Treasury in the presidential tax package in May 1985, to ensure that new funds made available to the FSLIC can be used to maximum effect in case resolutions.

SAVINGS INSTITUTION SELF-HELP PROGRAM FOR FUNDING THE FSLIC

The Task Force recommends the following three part program for funding the FSLIC:

Step 1:

The business would continue, if needed, to pay the special insurance assessment, which was first levied at the beginning of 1985, on the following six-year phase-down schedule:

1987	100.00%
1988	83.33%
1989	66.67%
1990	50.00%
1991	33.33%
1992	16.67%
1993 & Thereafter	0.00%

This would provide the FSLIC with the following funds from the special assessment (assuming that the business' deposits continued to grow at their estimated 1986 rate of 6 percent per year):

1987	$1.2 Billion
1988	$1.0 Billion
1989	$0.9 Billion
1990	$0.7 Billion
1991	$0.5 Billion
1992	$0.3 Billion
Total	$4.6 Billion

Combined with the FSLIC's regular premium income, this would provide the FSLIC with the following premium income over the next ten years:

1987	$2.0 Billion
1988	$1.9 Billion
1989	$1.8 Billion
1990	$1.6 Billion
1991	$1.5 Billion
1992	$1.3 Billion
1993	$1.1 Billion
1994	$1.2 Billion
1995	$1.3 Billion
1996	$1.3 Billion
Total	$15.0 Billion

The U.S. League strongly believes it is vital for savings institutions to see some end to the special insurance assessment. A savings institution with the same structure as a competitor commercial bank pays at least two and one-half times as much in insurance premiums because of the special premium.

The inequities become even more pronounced when one looks at the insurance burden on and derived insurance benefit for large commercial banks. These banks have less of their liability structure made up of domestic deposits than the typical savings institution. This means they are assessed insurance premiums on a smaller base when expressed as a percentage of their total assets. On the other hand, as shown by the case of Continental Illinois and as has been basically admitted by bank regulatory authorities, there is probably de facto insurance of 100 percent of liabilities of the largest commercial banks' because they are too big to be allowed to fail.

Thus, the typical savings institution faces two inequities in deposit insurance as compared to a large commercial bank:

- The premium rate is at least two and one-half times as large;
- The higher premium buys less insurance.

The problem with such a system, in addition to the obvious one of inequitable treatment, is that it encourages stronger savings institutions to migrate from the FSLIC-insurance system to that of the FDIC unless they can, at least, see an end to the special assessment.

This is one of the factors that most troubled the U.S. League about the bonding approach in the Treasury/Bank Board plan. Carrying costs of the debt would be so high and consume such a large amount of the income from the FSLIC's regular premium that it seemed likely there would not be an end to the special assessment in the foreseeable future. This would encourage strong institutions to leave the system, compounding the FSLIC's difficulties and probably leaving it with insufficient resources to resolve its problems.

Step 2:

A funding corporation would be set up which would, if needed, issue zero-coupon bonds which would be repaid from the dedication for that purpose of the 20 percent of net income that the Federal Home Loan Bank System currently sets aside in the so-called legal reserve and which is not available to pay dividends to member institutions.

The funding corporation would have the authority, if the cash resources of the FSLIC fell below some specific level, to raise up to $2.5 billion in such borrowings in the first year of the program and another $2.5 billion in the second year.

Appendix E outlines in detail how such a system would work. The appendix also points out that if the Bank System's earnings do not grow quickly enough, it is possible that the 20 percent of net income dedication might not be sufficient to retire the principal and accrued interest on the bonds. In that case, the difference would be made up by assessments on the business for the shortfall. In any year in which the business had to pay a special assessment, any required payment to the funding corporation to make up a Bank System deficiency in servicing the debt would represent a first call on the special assessment -- in other words, the payment to the funding corporation and the special assessment would never exceed one-eight of one percent of deposits, the statutory limit on the special assessment.

Step 3:

With the savings institution business being potentially asked to contribute huge amounts of resources to the FSLIC, the Bank Board should be accountable for their use by the insurance fund. Therefore, an oversight committee with representatives from the business would be statutorally established, the Bank Board would be required to report periodically to Congress on the use of the funds and the authority to continue to raise funds via the funding corporation would be subject to annual Congressional scrutiny.

Taken together, the steps in the savings institutions self-help program are schematically outlined in Exhibit 7.

RESOURCES FOR THE FSLIC UNDER THE INDUSTRY SELF-HELP PROGRAM

The following table gives the total external resources available to the FSLIC over different timeframes for the savings institution self-help program as compared to the Treasury/Bank Board proposal where it was contemplated raising $10 billion to $15 billion in borrowings over a four- to five-year period:

FSLIC CASH FLOW FROM EXTERNAL SOURCES UNDER INDUSTRY SELF-HELP PROGRAM AND TREASURY/BANK BOARD PLAN

Cash Flow Over:	U.S. League Savings Insts. Self-Help Program	Treasury/Bank Board Program	
		$10 Billion in Borrowings	$15 Billion In Borrowings
2 Years	$ 8.9 Billion	$ 8.7 Billion	$ 9.6 Billion
5 Years	$13.8 Billion	$16.8 Billion	$21.4 Billion
10 Years	$20.0 Billion	$19.0 Billion	$21.6 Billion
20 Years	$38.7 Billion	$29.7 Billion	$28.3 Billion

In other words, over the short-term (1987 and 1988), the industry self-help program would provide slightly more resources to the FSLIC than the Treasury/Bank Board plan. It would also provide significantly more over the long term since the FSLIC would not burdened with paying the interest on $10 billion to $15 billion in borrowings. Only when measured over a five-year horizon does the plan provide less than the Administration plan.

ADVANTAGES OF THE SAVINGS INSTITUTIONS SELF-HELP PROGRAM

1. One criticism leveled at the League's pay-as-you-go proposal was that it did not provide enough money in the short run for the FSLIC to solve its most pressing problems. However, the preceding figures show that the new self-help program could provide the FSLIC with external capital of $8.9 billion over the next two years, $200 million more than in the Treasury/Bank Board proposal if that proposal envisioned raising $10 billion in borrowings. Even if $15 billion in borrowings were raised under the Administration program, only $700 million more would be provided to the FSLIC over the first two years than in the League's plan.

In addition to these external resources, the FSLIC has its annual investment income and should soon see an inflow of cash from the disposition work of the Federal Asset Disposition Association and other workout efforts.

Thus, over the next two years, the FSLIC should have an inflow of funds of $10 billion or more, or an average of $5 billion per year -- $1.5 billion more in expenditures than the record level in fiscal 1986.

If the FSLIC were actually to spend more than $5 billion per year disposing of problem assets -- as against setting up accounting reserves for future problem resolution -- there is a real possibility it would be merely exacerbating its own problems, those of surviving savings institutions and of local economies in general. This is particularly true because the bulk of the FSLIC's problem assets are located in just a few states, and this activity would have a serious depressant impact on those economies.

Additionally, observers doubt that the FSLIC can spend more than $5 billion per year efficiently, particularly since it has had problems in attracting full-time personnel to staff its top positions. Also it must be remembered that until 1983, the FSLIC handled most of its problems through mergers. As a result, the FSLIC could traditionally operate with a small staff because it did not have a big liquidation operation. As compared to the FDIC, with more than 5,000 employees working on bank failures, the FSLIC received a tremendous assist from the industry through the merger process.

As a result, the FSLIC did not begin to face numerous or serious liquidation problems until 1984, when problem cases arising from negative interest rate spreads began to be overshadowed by cases typified by bad assets.

In response, the Bank Board and the FSLIC showed considerable ingenuity in designing innovative ways to handle the new situation. In particular, they initiated the MCP program and set up the Federal Asset Disposition Association to gain control of problem institutions and to convert non-earning assets to earning assets.

Nonetheless, like any business or government organization that faces rapid growth and a radical change in its operating environment, the FSLIC should be reorganized and updated. When an entity grows very rapidly, it is difficult to manage the growth, as typified by the problems at those savings institutions that grew rapidly.

The Bank Board has a task force working on a reorganization plan for the FSLIC. This is commendable and the U.S. League will support that effort. Meanwhile, however, it does not make sense to turn over large sums of money to an organization that does not appear, at this time, to be capable of handling and spending such sums efficiently.

In addition to the added resources the program provides the FSLIC, the agency also has available its own cash resources -- $4.6 billion at the end of September 1986. It is true that this figure is higher than the official reserves of the insurance fund. That is because some of its cash resources serve as backing for loss contingencies for the future -- particularly, the general loss contingency of $1.6 billion that was set up at the end of 1985. In an accounting sense, however, this is merely taking funds from one general reserve -- the insurance reserve -- into another general reserve -- the contingency for future losses.

Thus, over the next 10 years, the FSLIC will have up to $30 billion for use in case resolutions from external cash flow, investment income, asset disposition and from its initial resources, including those set aside as reserves for future losses.

2. Another criticism leveled at the League's pay-as-you-go proposal was that it lacked flexibility to provide even more funds for the FSLIC if its problems require them. The Treasury pointed out that, if necessary, its program could raise $15 billion or more instead of $10 billion through borrowings in capital markets. (Already concerned about the implications of borrowing $10 billion, savings institutions were not reassured that the borrowing exposure could rise to $15 billion or more.)

The League's revised program conserves flexibility. It does not consider touching the $2.2 billion currently held in retained earnings in the Federal Home Loan Bank System. If the $5 billion in borrowings that the League's program could raise over the next two years prove insufficient, Congress would have the option of using the $2.2 billion in retained earnings as backing for further borrowings along the lines of the Treasury/Bank Board program.

Furthermore, if the $10 billion or more provided to the FSLIC over the next two years is not sufficient for the fund's needs, then the League considers it appropriate that the Congress should revisit the issue rather than leave it administratively possible, without Congressional review, to continue burdening the system with further huge amounts of debt.

3. Over the next 20 years, the League's program is far cheaper than the Treasury/Bank Board proposal. When measured in present value terms, the cost of the special assessments and debt service under the League's alternative is far less than that of the Administration's -- $9.6 billion compared with $15.5 billion.

4. Over the next 20 years, the League's proposal could have the Bank System contribute $14.9 billion (with a current value of $5.8 billion) to retire the debt. The Treasury/Bank Board plan would tap the Bank System for $3 billion. However, the latter would be over a much shorter period -- three to five years. Furthermore, the contribution of the $14.9 billion is contingent on the Bank System being able to afford it. If the Bank System's earnings do not grow over the twenty-year period, its contribution would be limited to $5.5 billion, with a present value of only $2.7 billion.

The Administration's proposal would tap the Bank System's retained earnings for $3 billion regardless of the System's profitability.

5. Since part of the FSLIC's income stream would not be used to pay interest on borrowings the likelihood of being able to phase out the special assessment is increased. With the continuing debt service burden under the Administration plan, many observers believe the possibility of phasing down and eventually eliminating the special assessment is far more remote.

6. Because the service and repayment of the borrowings are coming from the Bank System and the business in the League's plan rather than representing a first call on FSLIC's income as in the Treasury/Bank Board plan, the League's proposal will not run into the same budget scoring problems from the Congressional Budget Office. With the Administration plan, the CBO gave only grudging approval last year and could change its position this year if it is again called upon for an opinion.

APPENDIX A: MODELS OF SUPERVISORY FORBEARANCE

The inflationary spiral of the 1970s and its cure in the 1980s have required that policy makers grapple with many dislocations in the economy. Huge amounts of taxpayer funds have been poured into the farming sector in an effort to preserve the nation's agricultural infrastructure. However, in an age of historically large federal budget deficits, most efforts to overcome economic dislocations have taken the form of time-buying stretchout strategies. These strategies provide models and precedents for helping well-managed savings institutions work out of problem situations whose cause is beyond those institutions' control.

In particular, three strategies adopted in the financial institution sector are relevant to the subject at hand:

A. Allowing savings institutions to work out of problems created by the high interest rate environment of the early 1980s;

B. The legislated accounting changes for the Farm Credit System, and

C. The forbearance guidelines adopted by the federal commercial bank regulators.

A. SAVINGS INSTITUTIONS' RECOVERY FROM EARLY-1980s DIFFICULTIES

In 1981-82, the vast majority of savings institutions suffered devastating operating losses as a result of a process of uneven deregulation coupled with interest rates at historically high levels. The carrying cost of newly-deregulated deposits soared while the return on mainly long-term fixed-rate assets remained relatively stagnant.

During these two years, FSLIC-insured savings institutions reported bottom-line losses of $8.9 billion, a staggering 26.7 percent of the aggregate net worth of the business at the end of 1980. Indeed, if the market value of their portfolios were computed at the height of the interest rate cycle, the vast majority of savings institutions would have been insolvent. Some observers predicted the end of the savings institution business.

Faced with a disaster of this magnitude, the only practical solution was to buy time and ride the crisis out. Congress adopted the Net Worth Certificate program, and the regulators allowed many institutions to operate below the minimum capital standards.

The results have been gratifying. In the first half of 1982, FSLIC-insured savings institutions had an annualized return on assets (ROA) of -0.82 percent. By the first half of 1986, the business had an ROA of +0.50 percent.

Even more remarkable is the turnaround in the business in some states. In the 1981-82 period, the business in the large "rust-belt" states experienced among the most pronounced difficulties. For instance, institutions in New York had an aggregate ROA of -1.51 percent, and in Illinois, of -1.0 percent. By the first half of 1986, institutions in New York posted an aggregate ROA of +1.18 percent and Illinois institutions an ROA of +1.12 percent. From being among the worst in the nation, in early 1986 institutions in these states turned in some of the best performances.

In a September 1986 report, the Government Accounting Office (GAO) maintained that the FSLIC "warehoused" at least 582 thrifts for some or all of the period 1982 to 1985. Allowing them the chance to work back to health was obviously beneficial to these institutions and the communities they serve. However, the GAO report bears eloquent testimony to the benefits to the FSLIC itself of taking a gradual approach to providing final solutions.

The time to dispose of institutions crippled by losses due to negative spreads was not at the peak of the interest rate cycle in 1981-82. By taking more of a wait-and-see attitude, the FSLIC saved itself billions of dollars. Specifically, the GAO found that, in examining 107 institutions that it claimed the FSLIC warehoused for all of the period between 1982 and 1985, the FSLIC realized:

> "...potential savings of approximately $3.0 billion due directly to delaying resolution of the thrifts' problems. However, because the FSLIC did not expend $5.3 billion in 1982, it neither depleted the insurance reserves nor borrowed (from the Treasury, for example). It was able to continue to earn interest on the fund's assets and avoid paying interest on any borrowings. In this way, it saved an additional $1.7 billion in interest over the three year period to December 1985. In total, we estimate that the FSLIC saved $4.7 billion by delaying resolution of 107 of the insolvent thrift cases in 1982." ["Cost to FSLIC of Delaying Action on Insolvent Savings Institutions", GAO, September 1986, p. 11]

It might be noted that the estimated $4.7 billion in savings almost precisely equals the $4.6 billion in cash and government securities the FSLIC had on hand at the end of September 1986. Were it not for the above savings, the FSLIC would now be totally out of resources.

As is evident from its title, the GAO study maintains that what worked in the past will not work in the future, i.e., that adopting a time-buying strategy for its current problems will cost rather than save the FSLIC money. This GAO contention is examined in detail Appendix D.

B. ACCOUNTING CHANGES FOR THE FARM CREDIT SYSTEM

In 1986, the Congress passed the Farm Credit Act Amendments, in which it legislated regulatory accounting provisions for the Farm Credit System (FCS) less than a year after it had mandated that the FCS keep its books in accordance with GAAP. The new legislation allowed the system to defer the recognition of certain excess costs and losses up to a period of 20 years. This was designed to allow the FCS to:

1. Delay the depletion of its capital;

2. Delay the need for a government bailout; and

3. Offer its borrowers loans with lower interest rates and, thus, encourage stronger borrowers to remain within the system.

As a dedicated lender to the troubled agricultural sector, the Farm Credit System has been devastated by losses, problem assets and stronger borrowers fleeing the system. In the 18 months from the beginning of 1985 through mid-1986, the FCS had losses of $3.8 billion and for the four-year period from 1985 through 1988 projected losses of $8.3 billion. By mid-1986, the system had nonaccrual and problem loans of about 20 percent of its portfolio.

The system has exposed itself to fluctuations in interest rates by funding variable rate loans with long-term fixed-rate bonds. As a result, it is doubly hit by a decline in inflation and interest rates. The FCS has an overhang of long-term, high-cost liabilities acquired in the early 1980s. Because of this the FCS has had to charge above-market rates on its loans. This has caused borrowers with other funding sources to flee the system. Moreover, such borrowers fear the loss of the FCS stock they are required to buy in order to borrow from the system. The result is a classic adverse selection problem evidenced in a rapid declining portfolio of loans outstanding (falling from $85 billion at the end of 1983 to $61.5 billion in June 1986), a decline in capital stock and a remaining customer base of weak borrowers.

To buy time for the system, the Farm Credit Act Amendments of 1986 legislated accounting changes for the FCS. Subject to prior approval from their regulator, the Farm Credit Administration, the Farm Credit banks can capitalize and write off over a period of up to 20 years:

1. The difference between the average interest rate on obligations incurred before January 1, 1985, and the rate on new obligations at the time of the passage of the legislation. The conference report estimated the difference to be 4.4 percent (10.6 percent on old obligations versus 6 percent on current ones). The effect is that the 4.6 percent annual excess cost on about $30 billion of obligations can be expensed over twenty years rather than over the 3-1/2 year average remaining life of the obligations.

2. The amount by which the banks actual loan losses and provision for loan losses during 1986 through 1988 exceed one-half of one percent of the loan portfolio (the level of provision for losses "ordinarily" maintained by the system).

In both House and Senate deliberations on this legislation, an interesting letter was read into the record that evidenced a pragmatic Wall Street view of the proceedings. The letter from the investment firm of Rothschild, Unterberg, Towbin, Inc., stated in part:

> "We are less concerned with the accounting treatment of FCS losses under the new act than the reality of the problems the FCS currently faces...

> The time when the FCS might ultimately require federal financial assistance will be postponed, and the additional breathing space the act provides improves the FCS chances of surviving independently. Since the FCS can fund the losses with cash raised in the capital markets, this solution is workable, and the ends certainly justify the means." [Congressional Record, October 17, 1986, pp. H 11458 and S 16945]

C. FORBEARANCE GUIDELINES FOR COMMERCIAL BANKS

Federal policy makers are faced with two serious dilemmas as they try to handle the unprecedented and still-growing number of weakened financial institutions. First, the deposit insurance funds are not equipped -- indeed, were not designed -- to close the books and liquidate a substantial amount of assets in the financial system in a short period. The funds were conceived more as a social insurance program to guarantee depositors a safe and reliable financial system than as a large repository of cash reserves ready to be expended at one time. Even to the extent that they resemble the operation of a private insurance company, they could not be expected to finance in a single year or several years the closing or recapitalizing of so many weakened institutions.

The second dilemma supervisors face is that while the economy and the financial sector generally have been enjoying a prolonged recovery, some industries concentrated in several regions of the country have been left behind. Consequently, a few hundred savings institutions and many hundreds of commercial banks that have been operated carefully and conservatively have gotten into trouble and in some cases are approaching insolvency. Their difficulties are typically caused by economic conditions beyond their control.

Recognizing these dilemmas, the three federal commercial bank regulatory agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Comptroller of the Currency) in a March 11, 1986 joint policy statement outlined a program of supervisory forbearance toward soundly managed banks heavily dependent on agriculture or the oil and gas industries.

In its implementing policy statement, the Comptroller of the Currency characterized the program as:

> "...supervisory policies that will support basically sound, well-managed banks in weathering what is expected to be a difficult but transitional period." [Federal Register, Vol. 51, No. 78, p. 15305]

The "difficult but transitional period" that prompted the regulators to move to this approach resulted from the economic dislocations discussed in an earlier section of this report. The program is to remain in effect for seven years from its inception in early 1986. For at least that period, the regulatory agencies were jointly acknowledging business-as-usual treatment of institutions tied to the distressed sectors of the economy does not make any sense. The Comptroller further explained:

> "Problems in the agricultural economy have directly affected the banks that provide financing for the agricultural sector. Severe financial pressures on borrowers dependent on the agricultural economy have resulted in an increase in loan delinquencies. As conditions have worsened, borrowers increasingly fear foreclosure, while bankers are increasingly concerned about supervisory actions that may result from reduction in their banks' capital as a consequence of loan losses." [op.cit. pp. 15305-15306]

The Comptroller's statement included these elements in the implementation of the forbearance program:

1. "...encouraging banks to work with their troubled agricultural and oil and gas borrowers..."

2. "...establishing a capital forbearance policy..."

3. "...encouraging the use of generally accepted accounting principles which may permit loan restructurings without loss recognition..."

4. "...relaxing lending limits." [op.cit. p. 15305]

The OCC and other regulatory agencies made it clear that poorly managed banks would not be able to take advantage of the forbearance measures. Examiners and supervisors retain authority to enforce sound banking operating standards. In outlining the capital forbearance portion of the program, for example, the OCC statement said:

> "The OCC reserves the right to terminate capital forbearance for banks engaged in unsafe or unsound or other objectionable practices, or if it becomes apparent to the OCC that the bank is unwilling or unable to comply with an acceptable capital plan." [op.cit. pp. 15306-15307]

Recognizing the segmented economy and pockets of depression, the bank regulators had earlier indicated their desire to avoid closing well-managed farm banks or unduly pressuring hard-hit agricultural borrowers by the supervisory actions taken against such banks. A joint statement in April, 1985, for example, reminded banks that the federal regulators wanted them where possible to:

> "...enter into work-out plans with agricultural borrowers who are experiencing temporary difficulties in meeting their debt service obligations." [op.cit. p. 15306]

The new joint statement renewed that encouragement with respect to farmers and extended the same attitude to oil and gas borrowers.

The capital forbearance element of the program, the Comptroller noted,

> "...formally acknowledges that capital should be used during periods of unusually heavy loan losses and that capital replenishment takes time." [op.cit. p. 15306]

The statement specified that the OCC "...will not take administrative action to enforce the minimum capital requirements..." in cases where the bank is an agricultural or oil and gas lender and its weakened capital position results from problems in those sectors of the economy. To qualify, the bank must satisfy the OCC that it is well-managed and that it has a workable plan to restore its capital to required levels by 1993. Applications for capital forbearance are automatically granted if the Comptroller's office does not respond within 60 days. Specifically:

> "Under the capital forbearance policy, the OCC will not take administrative action to enforce the minimum capital requirements ... against a bank whose primary capital ratio declines below 5-1/2 percent to no less than 4 percent before December 31, 1987" [op.cit. p. 15306]

provided that the bank meet certain requirements.

Further:

> "Upon written request of an agricultural/oil and gas bank and at the discretion of the OCC, the capital forbearance policy may be extended, in special circumstances, to a bank with a primary capital ratio lower than 4 percent." [op.cit. p. 15306]

The regulators' repeated encouragement over the past several years that banks enter into "work-out" agreements with troubled farm sector borrowers and the flexibility of the capital forbearance portion of the program were both made possible to some extent by another key element of the forbearance program: Permission for the affected banks to continue carrying slow paying or non-paying loans without recognizing them on their books as losses.

This seeming loophole in commercial bank regulatory discipline occurs because of the application of an accounting rule adopted in 1977 as part of GAAP by the Financial Accounting Standards Board.

The rule, known as Statement of Financial Accounting Standards No. 15 (SFAS 15), was written in essence to allow commercial banks to work their way out of weak or non-performing loans that remained on their books following the mid-1970s collapse of real estate investment trusts and the loan default by New York City. In effect, forbearance was written into the formal accounting rules.

In their forbearance program, the bank regulatory agencies advised farm and energy banks to consider using this restructuring technique to avoid a loan loss rather than taking "more precipitous action such as foreclosure." Use of SFAS 15 is justified where economic conditions have led to problem loans, the Comptroller's statement reasoned. It noted that the "downturns" were confined to certain parts of the economy and were expected to be short-lived. The Comptroller's statement described its position this way:

> "Although OCC examiners will point out to management the weaknesses that may be present in loans, the OCC does not require foreclosure on collateral or the acceleration of the maturity of loans. The OCC recognizes that downturns in certain sectors of the economy are expected to be transitory. Therefore, lenders may find that the most prudent policy is to restructure the loan terms rather than to take more precipitous action such as foreclosure." [op.cit. p. 15306]

The practical effect of this accounting rule that allows banks to avoid recognition of certain loan losses was outlined by the OCC as follows:

> "This standard allows a loan to continue to be carried on the bank's books without any loss recognition if the loan is formally restructured in a manner so that it is probable and estimable that the borrower can repay the loan under the new terms, and that the total future cash payments by the borrower (principal and interest combined) at least equals the loan amount on the bank's books." [op.cit. p. 15307]

In other words, while a substantial portion of any non-paying loan would normally have to be "written off" or deducted from a bank's income and capital as soon as it becomes apparent that it will not be repaid or that the borrower cannot meet the interest payments, a loan categorized as a restructured troubled debt can continue to be counted as a good asset -- even if no interest payment under the original terms of the loan is ever paid. The Comptroller's statement continued:

> "Accordingly, a bank which reasonably expects a borrower's future cash payments to equal or exceed the loan amount does not need to recognize a loss on the restructuring. In those situations where it is expected that the future cash payments on the restructured loan will be less than the loan amount, the loss recognized is limited to the expected cash flow deficiency." [op.cit. p. 15307] [emphasis supplied in OCC text]

Reporting and disclosure requirements for restructured loans were modified so they would not have to be reported as nonperforming assets if they perform according to the new loan terms. These loans would be reported instead as loans "restructured and in compliance with modified terms."

The bank regulators also adopted a relaxation of lending limits for banks whose capital is impaired and as a result would normally have to curtail the amount of their lending to a single borrower. The OCC explained:

> "...the declines in capital attributable to the problems in the oil and gas and agricultural sectors of the economy may cause some banks to be unable to serve the normal credit needs of a greater number of their creditworthy customers. In order to reduce the impact of these loan losses on a bank's ability to meet the legitimate credit needs of its financially sound customers, the OCC believes it necessary and appropriate to relax lending limits during the period in which the capital forbearance policy is in effect [i.e., through 1992]." [op.cit. p. 15307]

While the bank regulators' program may not offer a precise model for savings institution supervision, it contains a number of principles which are readily applicable:

- It is a time-buying strategy for well-managed institutions which happen to serve the needs of communities and industries severely affected by economic depression.

- It recognizes the value of preserving sound institutions at the relatively minimal cost of relaxing the rules temporarily.

- It endorses the concept of counting nonperforming debt assets at full value if there is a realistic prospect that the borrowers will pay them back after working their way through an economic downturn.

- It maintains the integrity of the supervisory process, keeping intact the power of supervisors to step in where unsafe and unsound practices are discovered, even where an institution is among those otherwise entitled to forbearance.

APPENDIX B: ACCOUNTING FOR PROBLEM LOANS:
GAAP vs. RAP ACCOUNTING PRACTICES

Currently, there are significant differences in the methods of accounting for problem assets on a generally accepted accounting principles basis and the basis of accounting which may be prescribed under regulatory accounting practices. Under regulatory accounting practices, the regulators have authority to require a savings institution to obtain an appraisal for a property securing a loan, and adjust the loan carrying value to the appraised value of the collateral property if the appraised value is less than the association's loan balance.

The regulatory rules require that such appraisal be performed under the guidelines of Memorandum R41c. R41c requires the appraiser to discount the property's expected sales price at a rate which, in almost all cases, will exceed the institution's cost of money. This discount rate is intended to compensate a current purchaser of a property for 1) interest cost of carry, 2) risk, and 3) profit. This "deep discounting" typically results in the R41c appraised value of a property being significantly lower than the net carrying value of a problem loan valued on the basis of generally accepted accounting principles.

Under generally accepted accounting principles, a loan receivable is carried at the lesser of cost or 1) net realizable value, or 2) a carrying value determined in accordance with the provisions of SFAS 15 relating to troubled debt restructuring where the original obligor remains in place.

The valuation on the basis of net realizable value results in the institution discounting future net cash flows from the sales and net revenues associated with the property at the institution's cost of money. Since the institution's cost of money rate will almost always be lower than the discount rate used by an appraiser in appraising a property on the basis of R41c, the asset's regulatory carrying value will be reduced to a level below the carrying value required under generally accepted accounting principles.

In a troubled debt restructuring in accordance with SFAS 15 where the original borrower remains in place and the terms of the receivable are modified only as to interest rate and/or term, a discount rate as low as 0 percent may be used in establishing the carrying value of the related loan. The use of this lower interest rate, then, results in the carrying value of the asset being higher than the carrying value if the asset was valued on the net realizable value basis, and significantly higher than if valued on the basis of an R41c appraisal.

The Task Force believes the Bank Board should adopt generally accepted accounting principles for purposes of establishing reserves for loan losses. In cases where it is appropriate to determine the net realizable value under generally accepted accounting principles, the carrying value will be set at an amount more closely in line with the actual value to be received by the institution net of all costs (including interest costs) of carrying a property to its final disposal. This represents a far more accurate accounting for the asset than the accounting permitted under regulatory accounting principles, involving an R41c appraisal.

The use of an R41c appraisal under regulatory accounting results in larger than actual losses being recorded at the time a problem loan is identified and reserved for, with resulting profit pick-up at the time of sale in the future. This method unnecessarily penalizes the current period's operations and results in offsetting gains in future periods.

To illustrate the differences in the application of the three different accounting methods, consider the following example of a troubled loan. In this example, it is assumed that the appraiser and management agree upon the following assumptions:

Troubled Loan Balance	$10 million
Leasing Status	50% leased with substantial leasing concessions for the first two years.
Projected Net Operating Income:	
Year One	$ 0
Year Two	0
Year Three	400,000
Year Four	800,000
Year Five	1,000,000
Cost of Funds	7.9%
Discount Rate used by Appraiser	13.0%
Assumed Value of Collateral Building at the End of Five Year Period	$10 million
Out-of-Pocket Payments to be Made by Borrower (Secured by Letter of Credit)	$100,000 per year in years one through five.

Following is an exhibit demonstrating the impact of the three different accounting methods on the financial statements of an association over the remaining five year period of the loan.

	Year One	Year Two	Year Three	Year Four	Year Five	Total
Regulatory Income						
Loss on Write Down to Appraised Value	$(3,262,000)	0	0	0	0	$(3,262,000)
Investment Income	100,000	$100,000	$500,000	$900,000	$1,100,000	2,700,000
Gain on Disposition of Loan	0	0	0	0	3,262,000	3,262,000
Net Income Effect of Accounting Policy	$(3,162,000)	$100,000	$500,000	$900,000	$4,362,000	$2,700,000
GAAP Net Realizable Value						
Loss on Write Down of Loan	(1,012,000)	0	0	0	0	(1,012,000)
Investment Income	674,000	717,000	764,000	783,000	774,000	3,712,000
Gain on Disposition of Loan	0	0	0	0	0	0
Net Income Effect of Accounting Policy	(338,000)	717,000	764,000	783,000	774,000	2,700,000
FASB Troubled Debt Restructuring Accounting						
Loss on Restructure of Loan	0	0	0	0	0	0
Investment Income	512,000	533,000	555,000	558,000	542,000	2,700,000
Gain on Disposition of Loan	0	0	0	0	0	0
Net Income Effect of Accounting Policy	$512,000	$533,000	$555,000	$558,000	$542,000	$2,700,000

APPENDIX C: BACKGROUND ON RECAPITALIZATION

The drive to inject additional funds into the Federal Savings and Loan Insurance Corporation (FSLIC) started in 1985 with a proposal from Federal Home Loan Bank Board Chairman Edwin Gray to adopt a variation on the 1 percent capitalization of the National Credit Union Share Insurance Fund which had been completed a year earlier.

Existing law authorizes the Bank Board to require FSLIC-insured institutions to make deposits to the fund of up to 1 percent of their insured savings accounts. That provision had been incorporated in the FSLIC law at a time when the major fear for the insurance fund was a shortage of readily available cash -- a liquidity crisis -- which might jeopardize its ability to pay depositors of failed institutions. However, while a deposit from institutions would improve the fund's cash position, it would do nothing to strengthen its balance sheet. And the problem of the 1980s is a shortfall of equity -- a balance sheet problem -- rather than a lack of liquidity.

Recognizing this flaw in the 1 percent deposit authority, the Bank Board offered a plan to modify that authority. The amount contributed would be the same 1 percent of an institution's insured deposits, but instead of being a loan to the FSLIC, it would take the form of a capital investment for the FSLIC which the FSLIC could count as reserves.

It was envisioned that institutions could count the 1 percent contribution on their balance sheets as assets just as they could presumably count a 1 percent deposit. Accounting experts warned, however, that the "asset" to be carried by the institutions would be of doubtful collectibility and, hence, of doubtful value inasmuch as it would likely be destined for use in the resolving problem cases.

Meanwhile, the Bank Board moved on the regulatory, supervisory and other fronts with a number of steps aimed at containing problem cases and minimizing the eventual cost of their resolution. These included establishing the Federal Asset Disposition Association (FADA), a federally-chartered association set up to help realize the maximum return on defaulted properties and other assets held by insolvent institutions; initiation of the management consignment program (MCP) under which management teams borrowed from healthy institutions could be put in charge of troubled institutions sustaining large losses; moving the examination staff to the jurisdiction of the twelve regional Federal Home Loan Banks so they would be nearer to the institutions they were charged with examining and so their numbers and levels of expertise could be enhanced without the need to deal with federal pay and head count limitations; and creation of a new Office of Enforcement at the Bank Board with a staff separate from that of the Office of General Counsel.

The Bank Board at this point also had been working to impose controls over excessive deposit growth and risky operating practices at some institutions to which the Board attributed a large share of the blame for its increased problem institution caseload. Having tried unsuccessfully in 1984 to slow the growth of deposits at rapidly growing institutions by means of a regulation virtually banning the use of brokered insured deposits, the Bank Board turned to a more direct linkage between growth and capital.

In January 1985, the Board issued regulations tightening capital requirements, and hence limiting growth unless accompanied by sufficient capital. Even more pointedly, it required institutions that intended to grow at an annual rate in excess of 25 percent to first obtain approval from the supervisory authorities. The Board also asserted a federal oversight role with respect to the approval of direct investments by state-chartered institutions in real estate, equity securities and service corporations, to the extent that an institution intended to hold such investments which, in the aggregate, would amount to more than 10 percent of assets or twice net worth.

These regulations typify a broad and impressive move by the Bank Board in this period to limit the drain on the FSLIC fund by preventive measures. A later example of such rules was the new minimum net worth requirements in August, 1986, which mandate an eventual net worth level of at least 6 percent of assets for all institutions.

The effect of the rules was to impose a new, tighter discipline on all operators with the hope that those endangering their institutions and the FSLIC would be reined in. It should be noted that the U.S. League of Savings Institutions, while reserving the right to comment on specific aspects of various proposals, vigorously endorsed the policy of imposing more discipline on high-flying institutions. Indeed, the League took the initiative of a leadership role in calling for such discipline.

But all along, as the FSLIC's problem caseload continued to mount, the Bank Board made it clear that it still viewed recapitalization as an essential ingredient for a healthy FSLIC.

In November, 1985, U.S. League Chairman Gerald Levy appointed a task force to craft solutions to the funding problems of the FSLIC. The task force developed, and the U.S. League Board of Directors approved, a comprehensive set of recommendations. These included a recapitalization program which envisioned meeting the FSLIC funding shortage by agreeing, on a schedule phased down over time, to the continuation of the special insurance assessment on the business first imposed at the beginning of 1985 and by transferring to the FSLIC part of the Federal Home Loan Banks' capital surplus and future earnings. Together with other sources of FSLIC funds -- regular premiums and investment income -- this plan was projected to provide the FSLIC with total resources of $27 billion over the next 10 years.

In addition, the task force recommended 23 other remedial steps to be taken by the Federal Home Loan Bank Board, the FSLIC, Congress and the savings institutions business. Among them were techniques to give regulators early warning of impending trouble at institutions so they could stop behavior which led to failures or take control of failing institutions before they built up large losses. In general, the recommendations called for supervisors to get tough with the few managers who were operating imprudently and posed the greatest risks to the insurance fund and ultimately to the entire savings institution system.

While the U.S. League plan was being formulated, the U.S. Treasury and the Federal Home Loan Bank Board were also working on a plan to recapitalize the FSLIC. On the day the League's plan was to be publicly announced in Washington, the Treasury/Bank Board plan was outlined in press accounts.

As it happened, each proposal envisioned accumulating almost exactly the same total sum, although over slightly different periods. The fundamental difference between the two plans was that the one developed by the administration authorities called for borrowing most of the money to be used in case resolution from the capital markets, while the League's plan provided for the funds to be obtained as needed from internal resources of the savings institution business including the Federal Home Loan Bank System which is owned by savings institutions. Because it provided funds on an as-needed basis without borrowing, the League's proposal became known as the "Pay-as-You-Go" plan.

The borrowing in the administration plan would be undertaken through a specially created financing entity issuing bonds in the capital markets to raise between $10 billion and $15 billion. A $3 billion transfer from the Federal Home Loan Banks' reserves would be invested in zero coupon Treasury securities which in turn would be eventually used to repay the principal of these bonds. Interest on the bonds would become an ongoing obligation of savings institutions through their deposit insurance premiums and assessments. Over time, this debt service would amount to between $16 billion and $24 billion on the assumption that the bonds would have a maturity of 20 years.

The Administration submitted legislation to Congress to authorize this bonding approach to FSLIC recapitalization. The House and Senate Banking Committees adopted the plan and sent it to the full House and Senate. However, support for the bonding program with its enormous debt service burden was understandably shallow in the savings institution business. Moreover, related issues such as the proliferation of non-bank banks were linked to recapitalization by various members of Congress. To further complicate the plan's prospects, the Congressional Budget Office raised a serious question as to whether the proceeds raised by the bonds could be given the needed scoring as a government receipt for budget purposes. The latter question was subsequently resolved, but only after weeks of delay.

Thus, the plan stalled until the final weeks of the 99th Congress when the Senate Banking Committee Democratic spokesman, Senator Proxmire, proposed a compromise. The bonding plan would be limited to one year at the outset and a ceiling of $3 billion in bonding authority would be imposed. Subject to Congressional approval, the bonding authority could be renewed for subsequent years, if needed.

The Administration at first rejected the one-year compromise but in the closing hours of the session agreed to it. By then it was too late for action to be completed.

The U.S. League in November reconstituted its FSLIC Task Force with an added mandate to examine the regional economic problems affecting many of the nation's financial institutions and -- following the innovative example of the commercial bank regulators' forbearance guidelines issued in 1986 -- to develop recommendations for handling those institutions' problems without resorting to wholesale closings.

The program developed by the Task Force is described in the main body of this report.

APPENDIX D: IS THERE A COST TO THE FSLIC IN DELAYING ACTION IN THE FINAL RESOLUTION OF PROBLEM CASES?

One of the major criticisms of the U.S. League's pay-as-you-go plan is that it did not provide enough resources immediately to the FSLIC to allow it to solve its most pressing problems quickly. Implicit, and indeed sometimes explicit, in this criticism was the assertion that by not taking final action swiftly in dealing with problem institutions, the ultimate cost to the FSLIC would be greatly increased since the size and severity of the problems at such institutions would continue to grow.

This contention can be questioned on many grounds:

1. It is reasonable to assert that if problem institutions are left untended, the exposure of and eventual cost to the FSLIC will likely be increased. However, bringing such institutions under control is not necessarily synonymous with crafting a final resolution. The Bank Board has many ways of ensuring that institutions do not continue to increase the risks to the FSLIC. These include replacing management and boards of directors or formally taking the institution over and putting it in the Management Consignment Program. Indeed, responsible savings institutions, burdened with billions of dollars in special insurance assessments, affirmatively demand that the Bank Board ensure that such institutions are not allowed to continue to act in a manner likely to cost the industry even more money in the future.

   Assets taken over by the FSLIC can be conserved from further deterioration by active management through the auspices of the Federal Asset Disposition Association, through management by responsible institutions recruited through the Management Consignment Program or through other means.

   Once deterioration is halted, an informed decision can be made as to whether the best course is to dispose of such assets, bring them to completion if they are in the development stage or manage them on an income-producing basis. If immediate disposition is to the FSLIC's, the business' and, where appropriate, the community's advantage then that option is open. Providing further options that could increase the return to the FSLIC can only be to the fund's advantage.

2. Adopting a rapid approach to the disposition of problem assets can actually be expensive for the FSLIC. As pointed out elsewhere in this report, the problem assets the FSLIC has taken over are concentrated in a few states, most notably states that are mired in economic difficulties. If the FSLIC were to dispose of those assets immediately, it would likely be doing so at fire-sale prices.

   In addition, these disposition efforts could further erode real estate values in those areas. This would lessen the return to the FSLIC itself, cause increased difficulties to other operating financial institutions and, generally, serve to deepen the depression in the affected areas.

3. An analogy to this situation was the plight of savings institutions in the unfavorable interest rate environment in 1981-82. As pointed out in Appendix A, by taking an essentially wait-and-see attitude at that time, the FSLIC saved itself $4.7 billion according to calculations by the GAO.

EXHIBIT 4: THE TWELVE STATES WITH THE MOST COMMERCIAL BANK FAILURES IN 1985 AND 1986

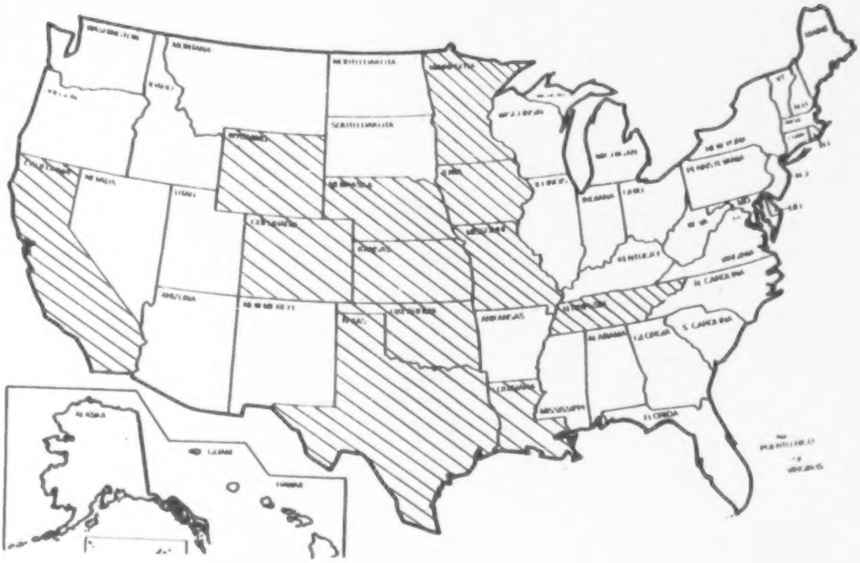
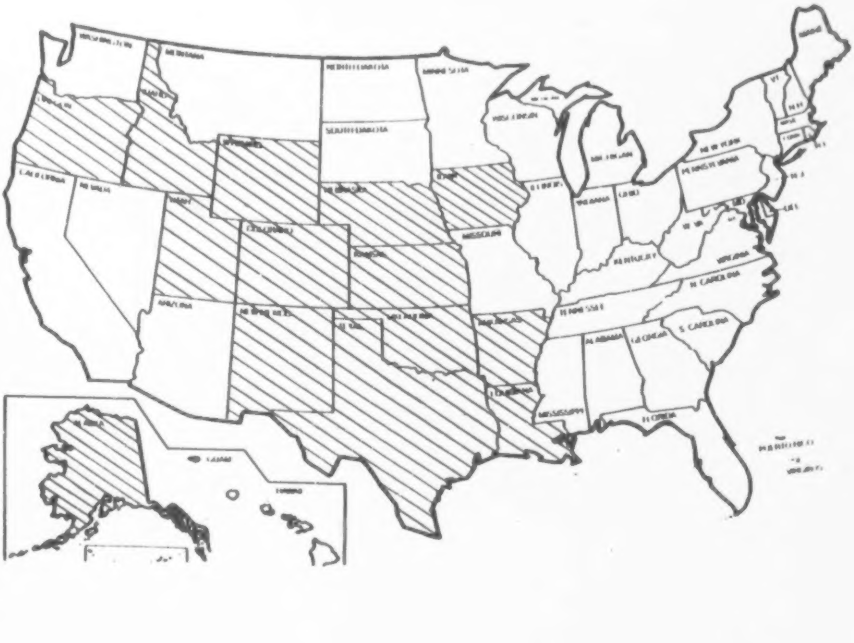

SOUTH DAKOTA
KENTUCKY
N CAROLINA
ARKANSAS
ALABAMA
GEORGIA
S CAROLINA
MISSISSIPPI
FLORIDA
ALASKA

EXHIBIT 5: THE FOURTEEN STATES WHERE SAVINGS INSTITUTIONS LOST MONEY, ON THE AVERAGE, IN THE FIRST HALF OF 1986


SOUTH DAKOTA
MISSOURI
KENTUCKY
N CAROLINA
ALABAMA
GEORGIA
S CAROLINA
MISSISSIPPI
FLORIDA

On the other hand, the GAO has been widely quoted as saying the FSLIC would suffer losses if it continued to "warehouse" insolvent thrifts until the end of 1987. For instance, in a transmittal letter to Rep. Doug Barnard, the Chairman of the House Subcommittee on Commerce, Consumer and Monetary Affairs, the GAO stated:

> "Our simulations predict that the FSLIC may lose over $1.4 billion from warehousing 367 thrifts from December 1985 to December 1987 if interest rates do not change in this period. Moreover, even modest increases in interest rates result in substantially higher costs to FSLIC. Only if interest rates fall do our simulations predict that there will be a continued pattern of apparent savings to FSLIC." ["Cost of Delaying Action on Insolvent Savings Institutions", GAO, September 1986, pg. 4]

There are many problems with the methodology in the GAO study but its conclusion that there is a significant cost to FSLIC in delaying action has been widely accorded the infallible status commonly granted to government statistics.

However, if the GAO study is given credibility it shows, in fact, that the FSLIC will save somewhere approaching $4.5 billion by warehousing the 367 so-called insolvent thrifts from December 1985 to December 1987. (This is in addition to the $4.6 billion the GAO computed as being saved by warehousing 107 insolvent thrifts from December 1982 to December 1985).

The GAO is explicit in this. For the level of interest rates over the 1985-87 period, it uses a mortgage rate of 11 percent. The study states:

> "...about $4.5 billion could be saved if interest rates fall
> by 2 percentage points" [op.cit. pg. 20]

This is basically what has happened since mortgage rates are approaching the 9 percent level in many parts of the country.

With its methodological problems, the cost-savings referred to by the GAO study may not actually be forthcoming. However, neither is it possible from the GAO's numbers to prove that there is a cost to the FSLIC in delaying final resolution on problem cases.

APPENDIX B: LEVERAGING 20 PERCENT OF THE FEDERAL HOME LOAN BANK SYSTEM'S NET INCOME

Under current rules, the Federal Home Loan Banks are required to place 20 percent of their income each year in what is called the legal reserve. Thus, this portion of their income is not available for use as dividend payments to their owners, the member savings institutions.

The U.S. League's funding plan for the FSLIC calls for dedicating this part of the Bank System's income stream to servicing possible borrowings by the FSLIC of up to $5 billion.

Specifically, if needed, a funding corporation would be established to issue long-term zero-coupon bonds. This corporation would then set up a sinking fund to retire the principal and interest on these bonds at the end of 20 years.

The Bank System would annually contribute to the funding corporation the greater of $275 million -- 20 percent of its estimated 1986 net income -- or 20 percent of its prior year net income. To ensure that the burden of contributing to the funding corporation did not fall unevenly on the individual banks or to obviate the possibility of a particular bank shirking its responsibility through minimizing its earnings, the net income for the system as a whole would be used as the calculation base. Twenty percent of this combined net income figure would be calculated. The resulting contribution would be levied on each bank by using the ratio of total assets of FSLIC-insured institutions in its district to the total assets of all FSLIC-insured institutions nationwide.

Exhibit 8 shows that if the Bank System's income grows at 9.53 percent per year, dedicating 20 percent of that income would be sufficient to pay off, in the year 2007, the total principal and interest on $2.5 billion of zero-coupon bonds sold in 1987 and another $2.5 billion issued in 1988 (with a combined face value of $22.4 billion in 2007). This assumes that the bonds can be sold with an interest rate of 8 percent. It also assumes that funds paid into the sinking fund would earn at an annual rate of 5 percent, a conservative assumption. Because they would be earmarked to retire long-term debt, there is no reason why such funds could not be placed in longer-term investments higher on the yield curve.

Of course, there is no guarantee that the Bank System's earnings would grow enough each year to provide sufficient contributions to the funding corporation, although the System's earnings have grown at an average annual rate of 14.7 percent since 1978. However, the Bank System is forecasting that its earnings in 1987 will grow very little and might even shrink. There are two main reasons for this pessimistic forecast:

1. A sizable portion of the System's earnings for the last year or more was made up of income from penalties on the early prepayment of advances by borrowing institutions. This is essentially a non-recurring source of income; and

2. The Federal Home Loan Banks derive the bulk of their net income from earnings on their capital base. On other operations, they run at an essentially breakeven level. With the decline in interest rates, the earnings on their capital base have also declined.

If the System's earnings do not grow at the 9.53 percent necessary to pay off the borrowings, there would be a shortfall in contributions to the sinking fund. In that case, it is contemplated that the business would make up the difference.

However, it is also possible that the retained earnings of the Bank System could also be used as a reserve to help pay off the bonds if, after a period of, say, five years, it was determined that the resources already committed to solve the FSLIC's problems were sufficient and, therefore, it would no longer be necessary for then keeping the retained earnings in the background as a potential backing for future borrowings.

If the worst case scenario is assumed and Bank System earnings do not grow at all over the next 20 years (or if they decline), the Bank System would contribute the minimum $275 million each year. This would be sufficient to pay off the principal and interest on $2.1 billion of borrowings, leaving the business to pay off the principal and interest on the other $2.9 billion -- if a total of $5 billion is borrowed.

This represents the downside for the industry. To assume that the Bank System's earnings would be no higher 20 years from now than they are today is very pessimistic and, probably, totally unrealistic. If, for instance, the earnings of the Bank System grew at 5 percent per year, then the Bank System would be liable for the payment of interest and principal on $3.3 billion of the possible $5 billion in debt with the business being responsible for the other $1.7 billion.

The industry exposure under the U.S. League plan for various growth assumptions in Bank System earnings is compared in Exhibit 9 with the full special assessment which many feel would be the business' permanent inheritance under the Treasury/Bank Board plan.

EXHIBITS

EXHIBIT 1: SOURCES OF FSLIC EXTERNAL CASH FLOW UNDER ALTERNATIVE PROPOSAI

	U.S. League Pay-As-You-Go Plan	U.S. League Savings Insts. Self-Help Plan	Treasury/Bank Board Plan	
			$10 B.	$15 B.
TWO-YEAR CASH FLOW:				
Regular Premiums	$1.6 B.	$1.6 B.	$1.6 B.	$1.6 B.
Special Assessments	$2.2 B	$2.2 B.	$2.2 B.	$2.2 B.
Bank System Contribution	$2.1 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$5.0 B.	$6.0 B.
Subtotal	$5.9 B.	$8.9 B.	$8.9 B.	$9.9 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$0.2 B.**	$0.2 B.*
TOTAL	$5.9 B.	$8.9 B.	$8.7 B.	$9.6 B.
FIVE-YEAR CASH FLOW:				
Regular Premiums	$4.5 B.	$4.5 B.	$4.5 B.	$4.5 B.
Special Assessments	$4.3 B	$4.3 B.	$4.3 B.	$4.3 B.
Bank System Contribution	$4.0 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$12.8 B.	$13.8 B.	$18.8 B.	$23.8 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$2.0 B.**	$2.4 B.*
TOTAL	$12.8 B.	$13.8 B.	$16.8 B.	$21.4 B.
TEN-YEAR CASH FLOW:				
Regular Premiums	$10.4 B.	$10.4 B.	$10.4 B.	$10.4 B.
Special Assessments	$4.6 B	$4.6 B.	$4.6 B.	$4.6 B.
Bank System Contribution	$6.9 B.	$0.0 B.*	$0.0 B.*	$0.0 B.
Borrowings	$0.0 B.	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$21.9 B	$20.0 B.	$25.0 B.	$30.0 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$6.0 B.**	$8.4 B.
TOTAL	$21.9 B.	$20.0 B.	$19.0 B.	$21.6 B.
TWENTY-YEAR CASH FLOW:				
Regular Premiums	$29.1 B.	$29.1 B.	$29.1 B.	$29.1 B.
Special Assessments	$4.6 B	$4.6 B.	$4.6 B.	$4.6 B.
Bank System Contribution	$6.9 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$40.5 B.	$38.7 B.	$43.7 B.	$48.7 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$14.0 B.**	$20.4 B.
TOTAL	$40.5 B.	$38.7 B.	$29.7 B.	$28.3 B.

* Bank System Contributions do not go directly to the FSLIC. They are reflected instead as backing for the borrowings.

** Under the final version of the Treasury/Bank Board plan, the FSLIC does not actually pay the interest on the borrowings. Instead, the interest on the borrowings represent a first call on the premiums and/or assessments from the business. However, the interest payments are broken out as a separate obligation of the FSLIC in this table for the sake of clarity -- the net effect is the same. Under the League's self-help plan the Bank System (and perhaps the business) pays the interest.

Note: Detail may not add to total due to rounding.

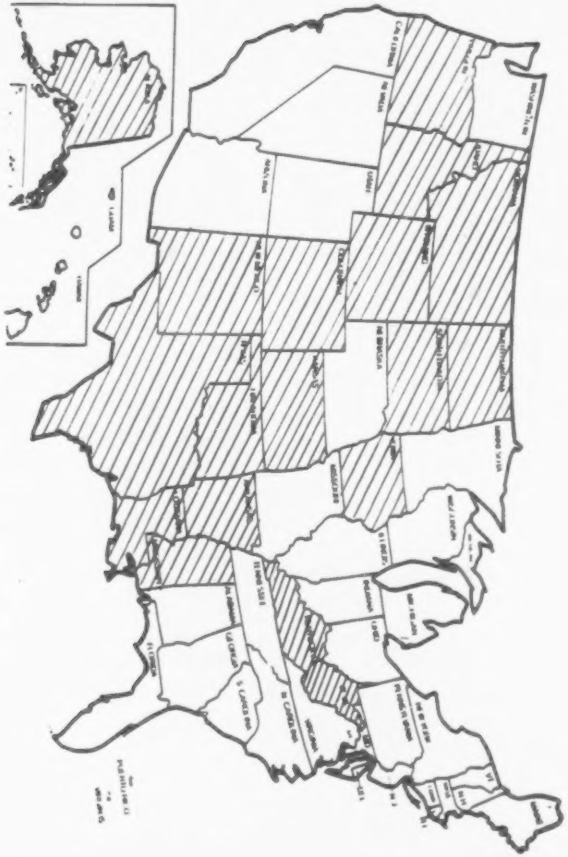


EXHIBIT 2: THE EIGHTEEN STATES WITH THE MOST SEVERE ECONOMIC PROBLEMS AS MEASURED BY UNEMPLOYMENT, PERSONAL INCOME AND HOUSING STARTS

EXHIBIT 3: BANKS CLOSED BY FDIC -- 1982-86

(States are Included Only if they had Bank Closings)

	1986	1985	1984	1983	1982
Alabama	1	2	1	1	1
Alaska	1	0	0	0	0
Arkansas	0	1	2	1	3
California	8	7	6	5	2
Colorado	7	6	2	1	0
Florida	3	2	2	0	1
Idaho	1	0	0	0	0
Illinois	1	2	5	6	5
Indiana	1	1	2	0	0
Iowa	10	11	3	0	2
Kansas	14	13	7	1	0
Kentucky	2	0	1	1	0
Louisiana	8	0	1	0	0
Massachusetts	0	0	0	0	1
Michigan	0	0	1	0	1
Minnesota	5	6	4	1	1
Mississippi	0	0	1	0	0
Missouri	9	9	2	1	2
Montana	1	0	0	1	0
Nebraska	6	13	5	1	0
Nevada	0	0	0	1	0
New Jersey	0	0	1	1	1
New Mexico	2	3	0	0	0
New York	0	4	0	2	4
Oklahoma	16	13	5	1	3
Oregon	1	3	5	5	0
Pennsylvania	0	0	0	0	1
Puerto Rico	1	0	1	1	1
South Dakota	1	0	1	1	0
Tennessee	2	5	11	12	3
Texas	26	12	6	3	7
Utah	3	1	1	0	0
Virginia	0	0	0	0	1
Washington	0	0	0	0	1
West Virginia	0	0	1	0	1
Wisconsin	1	1	0	0	0
Wyoming	7	5	2	1	0
Total	138	120	79	48	42

Sources: FDIC. American Banker. Wall Street Journal

EXHIBIT 6: FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

BALANCE SHEET -- SEPTEMBER 30, 1985 & 1986

ASSETS:	9/30/86	9/30/85	CHANGE
CASH & INVESTMENTS	$4,635,207	$5,761,337	($1,126,130)
SUBROGATED ACCOUNTS DUE FROM RECEIVERS	$6,115,864	$1,960,714	$4,155,150
ALLOWANCE FOR LOSS	($3,748,240)	($717,817)	($3,030,423)
COLLATERALIZED ADVANCES DUE FROM RECEIVERS	$663,257	$639,974	$23,283
LOANS TO RECEIVERS	$111,297	$0	$111,297
COLLATERALIZED LOANS TO INSURED INSTITUTIONS	$900,000	$900,000	$0
OTHER LOANS TO INSURED INSTITUTIONS	$120,141	$130,983	($10,842)
REAL ESTATE & MORTGAGES IN PROCESS OF LIQUIDATION	$402,714	$235,490	$167,224
INCOME CAPITAL CERTIFICATES	$2,270,642	$1,431,861	$838,781
ALLOWANCE FOR LOSS	($680,058)	($169,957)	($510,101)
NET WORTH CERTIFICATES	$288,500	$224,650	$63,850
OTHER ASSETS	($9,145)	$258,971	($268,116)
TOTAL ASSETS	$11,070,179	$10,665,206	$404,973

LIABILITIES:			
NOTES PAYABLE TO INSURED INSTITUTIONS	$3,692,541	$1,337,053	$2,355,488
NOTES PAYABLE TO FEDERAL HOME LOAN BANKS	$900,000	$900,000	$0
LOSS ALLOWANCE UNDER EXISTING ASSISTANCE AGREEMENTS	$686,687	$856,782	($170,095)
ESTIMATED CONTINGENT LIABILITY	$1,556,000	$0	$1,556,000
OTHER LIABILITIES	$597,811	$74,682	$523,129
TOTAL LIABILITIES	$7,433,039	$3,168,517	$4,264,522

INSURANCE FUND RESERVES:			
PRIMARY RESERVE	$2,824,956	$6,732,203	($3,907,247)
SECONDARY RESERVE	$812,184	$764,486	$47,698
TOTAL INSURANCE FUND RESERVES	$3,637,140	$7,496,689	($3,859,549)
TOTAL LIABILITIES AND RESERVES	$11,070,179	$10,665,206	$404,973

EXHIBIT 6 (Contd.): FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

INCOME STATEMENT FOR FISCAL YEARS 1985 & 1986

	FISCAL YEAR ENDED		
INCOME:	9/30/86	9/30/85	CHANGE
INSURANCE PREMIUMS	$724,284	$661,748	$62,536
SPECIAL ASSESSMENT	$1,063,159	$750,989	$312,170
INTEREST ON INVESTMENTS	$413,039	$539,610	($126,571)
PREMIUM ON TRANSFER OF ACCOUNTS	$118,607	$0	$118,607
OTHER INCOME	$68,490	$158,227	($89,737)
TOTAL INCOME	$2,387,579	$2,110,574	$277,005

EXPENSES:			
INTEREST ON NOTES PAYABLE TO INSURED INSTITUTIONS	$185,061	$92,441	$92,620
PROVISION FOR POSSIBLE FUTURE LOSSES ON:			
SUBROGATED ACCOUNTS DUE FROM RECEIVERS	$3,047,472	$591,968	$2,455,504
INCOME CAPITAL CERTIFICATES	$651,102	$77,207	$573,895
ASSISTANCE AGREEMENTS	$622,097	$571,560	$50,537
ESTIMATED CONTINGENCY	$1,556,000	$0	$1,556,000
OTHER	$60,109	$104,052	($43,943)
OTHER EXPENSE	$172,985	$179,418	($6,433)
TOTAL EXPENSES	$6,294,826	$1,616,646	$4,678,180
NET INCOME (LOSS) FROM OPERATIONS	($3,907,247)	$493,928	($4,401,175)
MEMO: TOTAL LOSS PROVISIONS	$5,936,780	$1,344,787	$4,591,993

SOURCE: FEDERAL HOME LOAN BANK BOARD

EXHIBIT 7: SAVINGS INSTITUTIONS'

SELF-HELP PROGRAM FOR FUNDING THE FSLIC

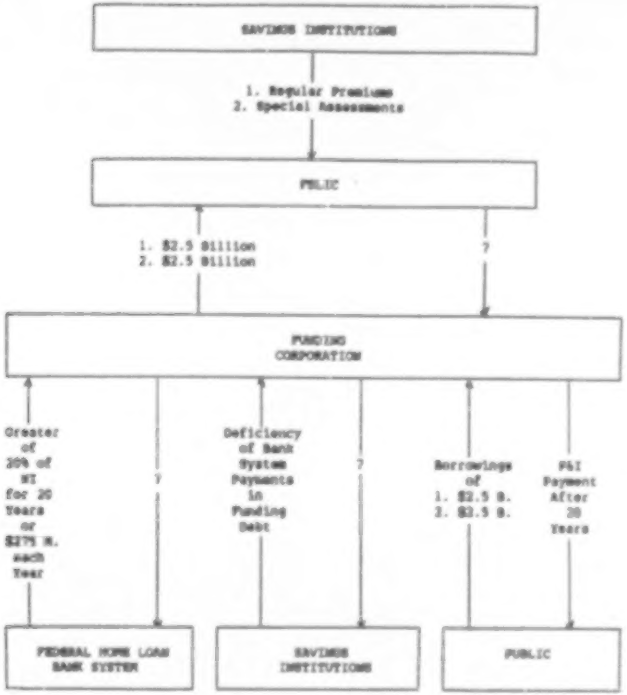

SAVINGS INSTITUTIONS
1. Regular Premiums
2. Special Assessments
FSLIC
1. $2.5 Billion
2. $2.5 Billion
?
FUNDING CORPORATION
Greater of 20% of NI for 20 Years or $275 M. each Year
?
Deficiency of Bank System Payments in Funding Debt
?
Borrowings of 1. $2.5 B. 2. $2.5 B.
P&I Payment After 20 Years
FEDERAL HOME LOAN BANK SYSTEM
SAVINGS INSTITUTIONS
PUBLIC

EXHIBIT 8: BORROWING CAPABILITY USING 20% OF

BANK SYSTEM NET INCOME

ASSUMPTIONS:	
TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
NEEDED GROWTH RATE OF SYSTEM EARNINGS	9.53%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	BANK SYSTEM CONTRIB-UTION	AMOUNT IN SINKING FUND	BORROWINGS OUTSTANDING PRINCIPAL & INTEREST
1986	$1,375			
1987	$1,506	$275	$275	$2,500
1988	$1,649	$301	$590	$5,200
1989	$1,807	$330	$949	$5,616
1990	$1,979	$361	$1,358	$6,065
1991	$2,167	$396	$1,822	$6,551
1992	$2,374	$433	$2,346	$7,075
1993	$2,600	$475	$2,938	$7,641
1994	$2,847	$520	$3,605	$8,252
1995	$3,119	$569	$4,355	$8,912
1996	$3,416	$624	$5,196	$9,625
1997	$3,741	$683	$6,139	$10,395
1998	$4,097	$748	$7,195	$11,226
1999	$4,488	$819	$8,374	$12,125
2000	$4,915	$898	$9,690	$13,094
2001	$5,384	$983	$11,158	$14,142
2002	$5,896	$1,077	$12,792	$15,273
2003	$6,458	$1,179	$14,611	$16,495
2004	$7,073	$1,292	$16,633	$17,815
2005	$7,747	$1,415	$18,880	$19,240
2006	$8,485	$1,549	$21,373	$20,779
2007			$22,442	$22,442
TOTAL	$81,749	$14,928		
PRESENT VALUE OF CONTRIBUTIONS		$5,838		

EXHIBIT 8 (Contd.): SHORTFALL IF BANK SYSTEM

EARNINGS DO NOT GROW

ASSUMPTIONS:

TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
GROWTH RATE OF SYSTEM EARNINGS	0.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	MINIMUM BANK SYSTEM CONTRIB.	SHORTFALL MADE UP BY THE BUSINESS	AMOUNT IN SINKING FUND
1986	$1,375			
1987	$1,375	$275	$0	$275
1988	$1,375	$275	$26	$590
1989	$1,375	$275	$55	$949
1990	$1,375	$275	$86	$1,358
1991	$1,375	$275	$121	$1,822
1992	$1,375	$275	$158	$2,346
1993	$1,375	$275	$200	$2,938
1994	$1,375	$275	$245	$3,605
1995	$1,375	$275	$294	$4,355
1996	$1,375	$275	$349	$5,196
1997	$1,375	$275	$408	$6,139
1998	$1,375	$275	$473	$7,195
1999	$1,375	$275	$544	$8,374
2000	$1,375	$275	$623	$9,690
2001	$1,375	$275	$708	$11,158
2002	$1,375	$275	$802	$12,792
2003	$1,375	$275	$904	$14,611
2004	$1,375	$275	$1,017	$16,633
2005	$1,375	$275	$1,140	$18,880
2006	$1,375	$275	$1,274	$21,373
2007				$22,442
TOTAL	$27,500	$5,500	$9,428	
AMOUNT OF DEBT COVERED		$2,127	$2,873	
PRESENT VALUE OF CONTRIBUTIONS		$2,700	$3,138	

EXHIBIT 8 (Contd.): SHORTFALL IF BANK SYSTEM

EARNINGS GROW AT 5% P.A.

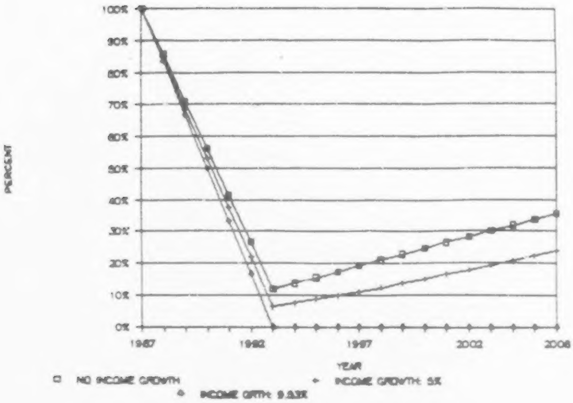
ASSUMPTIONS:

TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
GROWTH RATE OF SYSTEM EARNINGS	5.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	BANK SYSTEM CONTRIB.	SHORTFALL MADE UP BY THE BUSINESS	AMOUNT IN SINKING FUND
1986	$1,375			
1987	$1,444	$275	$0	$275
1988	$1,516	$289	$12	$590
1989	$1,592	$303	$27	$949
1990	$1,671	$318	$43	$1,358
1991	$1,755	$334	$61	$1,822
1992	$1,843	$351	$82	$2,346
1993	$1,935	$369	$106	$2,938
1994	$2,032	$387	$133	$3,605
1995	$2,133	$406	$163	$4,355
1996	$2,240	$427	$197	$5,196
1997	$2,352	$448	$235	$6,139
1998	$2,469	$470	$278	$7,195
1999	$2,593	$494	$326	$8,374
2000	$2,722	$519	$375	$9,690
2001	$2,859	$544	$439	$11,158
2002	$3,001	$572	$505	$12,792
2003	$3,152	$600	$579	$14,611
2004	$3,309	$630	$661	$16,633
2005	$3,475	$662	$753	$18,880
2006	$3,648	$695	$855	$21,373
2007				$22,442
TOTAL	$47,739	$9,093	$9,835	
AMOUNT OF DEBT COVERED		$3,251	$1,749	
PRESENT VALUE OF CONTRIBUTIONS		$3,948	$1,889	

EXHIBIT 9: MAXIMUM BUSINESS CONTRIBUTION IN LEAGUE PLAN

AS A PERCENT OF FULL SPECIAL ASSESSMENT



The CHAIRMAN. Thank you very much, Mr. Levy.
Mr. Gaiswinkler, you're up.

STATEMENT OF ROBERT S. GAISWINKLER, PRESIDENT, NATIONAL SAVINGS & LOAN ASSOCIATION, MILWAUKEE, WI; CHAIRMAN, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. GAISWINKLER. Mr. Chairman and members of the committee; my name is Robert S. Gaiswinkler, president of the National Savings & Loan Association in Milwaukee, WI. I am appearing today in my capacity as chairman of the National Council of Savings Institutions, a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our members include both FDIC and FSLIC insured institutions.

We are very pleased to accept your invitation to testify at today's hearings, and we commend your initiative in moving quickly to bring the FSLIC recapitalization and those other much-debated banking issues before the Banking Committee.

STATE OF THE INDUSTRY

I would like to begin by briefly reviewing the current state of the industry in order to establish the economic and financial framework against which our member institutions evaluate FSLIC recapitalization. Now, 98 percent of the council members are operating profitably; and for most of these institutions, their earnings are at a record high.

The Council's research department estimates that 1986 will be another record profit year for FDIC-insured savings banks. As a result, capital margins have increased dramatically in the last year, and we expect 1987 to indicate further positive results along this trend line. Average capital at FDIC-insured savings banks was

7.3 percent as measured by generally accepted accounting principles [GAAP].

Insofar as FSLIC-insured institutions are concerned, the overall economic picture shows similar earnings and capital improvement. However, there continues to be close to 400 FSLIC-insured institutions which have not been able to take advantage of the lower interest rate environment due primarily to problems relating to asset quality. As has been the case in commercial banking, these institutions are concentrated in those areas of the country which have been impacted adversely by the price decline in oil and agricultural products.

FSLIC GOING FROM BAD TO WORSE

While most FSLIC-insured institutions are thriving, the anomaly is that the health of the FSLIC is indisputably going from bad to worse. Based on estimates given by the Government Accounting Office and private studies, noncommitted reserves are less than $2 billion against total insured deposits approaching $1 trillion. Near-term—12 months—resolution costs are projected to be between $5 and $6 billion, and anticipated income from regular assessments, special assessments, and portfolio earnings are estimated to be $2.5 billion for 1987. The bottom line is that these numbers simply do not add up to a viable insurance alternative unless substantial new funds are injected within the next 6 to 12 months.

Responding to a congressional directive, the Treasury Department began in 1986 to develop a borrowing program premised on a capital contribution of up to $3 billion from the Federal Home Loan banks. These funds would be used to establish a financing corporation which could support as much as $15 billion of off-budget capital market borrowings.

In June 1986, the National Council task force studying this issue recommended support for the Treasury-Federal Home Loan Bank Board plan with certain changes, and both the Treasury and the Congress were generally responsive to these suggestions when the bill was being debated last year. On January 12, 1987, we reconvened our task force and, after considerable debate and examination of a number of different options, it was agreed that the Council should continue to support the Federal Home Loan Bank-Treasury plan. In fact, Mr. Chairman, because conditions at the FSLIC have materially worsened during the intervening months, we are now prepared to support immediate enactment of a FSLIC recapitalization measure regardless of whether our recommendations are addressed now or deferred for subsequent consideration.

We take this position because the indisputable fact is that in the absence of a substantial new infusion of capital FSLIC will be unable to deal with its current, let alone future, case resolutions. The anticipated cost of this effort is known to be at least $10 billion in 1987, with the eventual figure rising in fairly short order to $25 billion according to the estimates made yesterday before the committee by Under Secretary Gould and Federal Home Loan Bank Board Chairman Gray. This is not an amount which can be met through current and special assessments and earnings on reserves. Nor is it an amount which can be handled in a business-as-usual manner. Resolution costs have already been stretched out too long and in too many cases.

The real risk of inaction is that the healthy section of the thrift industry which I have described will be irreparably injured by the inability of the FSLIC to handle its current problems. We estimate, for example, that the costs of generating deposits as an FSLIC-insured thrift is approximately 50 basis points higher than the cost of raising liabilities for a similarly situated FDIC-insured bank. This disparity is largely the result of the perceived weakness of the FSLIC fund in too many cases.

In closing, I would like to thank you again for the opportunity to testify. Our basic message is that the declining state of the FSLIC finances constitutes a problem of major proportions requiring immediate action. We urge the committee to support the Treasury-Federal Home Loan Bank plan and bring this matter before the full Senate for expeditious results.

[The complete prepared statement follows:]

Statement of

Robert S. Gaiswinkler
on behalf of the
National Council of Savings Institutions

Mr. Chairman and Members of the Committee, my name is Robert S. Gaiswinkler, President of the National Savings and Loan Association, Milwaukee, Wisconsin. I am appearing today in my capacity as Chairman of the National Council of Savings Institutions, a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our members include both FDIC and FSLIC-insured institutions, an increasing number of which do business as either savings and loan holding companies or bank holding companies registered with the Federal Reserve Board.

We are very pleased to accept your invitation to testify at today's hearings, and we commend your initiative in moving quickly to bring the various subjects of today's hearings before the Banking Committee. As is well known, there has been no major banking legislation enacted during the course of the last two Congresses, and many issues, particularly FSLIC recapitalization, require prompt attention this year.

STATE OF THE INDUSTRY

Before commenting on the five issues mentioned in the Committee hearing notice, I would like to begin by reviewing briefly the current state of the industry in order to establish the economic and financial framework against which our member institutions evaluate these legislative issues. Ninety-eight percent of the Council members are operating profitably; and for most of these institutions, their earnings are at a record high. Thus, I would like to take just a moment to dispell the erroneous impression created by the over-publicized problems of the FSLIC and the relatively small number of unprofitable institutions that the state of the thrift industry is one of declining economic performance. In fact, Mr. Chairman, nothing could be further from the case.

The transition of the thrift industry from highly regulated, specialized institutions with extensive government controls over both the price payable on deposits and the range of permissible activities, to today's more competitive environment of no interest rate ceilings and expanded investment opportunities has been extremely successful. Deregulation is not only working, but has worked well for the vast majority of thrifts and commercial banks.

The deregulation of deposit rate ceilings has ended the recurrence of deposit outflows when interest rates rise and has resulted in billions of dollars of added income for consumers, small businesses, and others who choose to entrust their funds to federally-insured depository institutions. On the asset side, deregulation has helped thrift institutions return to profitability and has spawned a proliferation of financial services, frequently at lower costs and across a broader geographic area. These developments represent the often untold story of financial deregulation.

It is certainly true that not all financial institutions have been equal to the tasks of restructuring assets, cutting costs, realigning products, and controlling growth that are the keys to success in a deregulated environment. For thrift institutions, in particular, there were many which were never able to overcome the fact that deposit deregulation preceded asset deregulation during the period of the early 1980s before interest rates fell to the favorable levels that have prevailed over the last three years. Candor also requires us to recognize that there were, unfortunately, too many instances of self-inflicted failures brought about by undercapitalized thrifts stretching for excess income by adding risky assets to their balance sheets.

I am pleased to report, however, that general conditions have evolved to the point where our research department estimates that 1986 will be another record profit year for FDIC-insured savings banks. In fact, as of the third quarter of 1986, only one FIDC-insured savings bank had not returned to profitability.

Reflecting both the favorable interest rate environment that I have previously mentioned, as well as the portfolio restructuring accomplished by many institutions, the surplus accounts of FDIC-insured savings banks rose at an annualized rate of 96 basis points on average assets in the third quarter. As a result, capital margins have increased dramatically in the last year, and we expect 1987 to indicate further positive results along this trend line.

Annualized Net Change in Savings Bank Surplus as Percentage of Average Assets, Quarterly

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Calendar Year
1986	.48%	.52%	.96%		
1985	.30	.40	.35	.55%	.40%
1984	*	-.12	.16	.29	.08
1983	-.04	.32	.17	.15	.15
1982	-.92	-.88	-.64	-.35	-.86
1981	-.48	-.76	-1.08	-1.20	-.86
1980	.28	.40	-.32	.04	-.10
1979	.68	.56	.44	.24	.47
1978	.60	.72	.56	.40	.57
1977	.60	.60	.56	.44	.55
1976	.40	.44	.56	.36	.44

* = Less than .005 percent.

Note: Data refer to net changes in surplus, undivided profits, reserves from retained earnings and exclude debentures, capital infusions from FDIC, net worth certificates and net stock issues.

Average capital at FDIC-insured savings banks was 7.3 percent as measured by Generally Accepted Accounting Princpals (GAAP). As indicated by the following chart, savings bank capital positions have recovered fully and have now returned to the historic levels that prevailed prior to the extreme financial stress of the early 1980s.

Ratio of General Reserve Accounts to Assets of Savings Banks 1975-1986

1986p	7.32%
1985	5.92
1984	5.12
1983	5.36
1982	5.30
1981	5.68
1980	6.63
1979	7.05
1978	6.90
1977	6.77
1976	6.71
1975	6.96

p = preliminary, based on October, 1986 data

On the savings and loan side, the economic picture shows similar earnings and capital improvement, as well as the traditional, more positive deposit growth than is the case with savings banks which are predominantly located in the Mid-Atlantic and New England regions of the country. On the negative side, there continue to be close to 400 FSLIC-insured institutions which have not been able to take advantage of the lower interest rate environment due primarily to problems relating to asset quality. As has been the case in commercial banking, these institutions are concentrated in those areas of the country which have been impacted adversely by the price decline in oil and agricultural products.

Notwithstanding these regionalized problems, we estimate that 1986 will be another year of strong profits for savings and loan associations and that the industry will continue making major strides in rebuilding its net worth. Retained earnings, as indicated below, have declined somewhat from a year earlier, reflecting a considerable writedown of foreclosed real estate, particularly among those institutions in the so-called Management Consignment Program.

Retained Earnings as Percentage of Total Assets of Savings and Loans 1975-1986

Year	Percent
1986p	0.21%
1985	0.27
1984	0.15
1983	0.27
1982	-0.64
1981	-0.73
1980	0.13
1979	0.67
1978	0.81
1977	0.77
1976	0.63
1975	0.47

p = preliminary

Just recently, the FHLBB increased regulatory capital requirements to 6 percent for FSLIC-insured institutions with a transition period geared to average industry earnings. Based on realistic interest rate predictions, we see no reason this target cannot be met by most institutions before the end of this decade.

FSLIC RECAPITALIZATION

While FSLIC-insured institutions, in the aggregate, are thriving, the anomaly is that the health of the FSLIC is indisputably going from bad

to worse. Based on estimates made by the Government Accounting Office and private studies, non-committed reserves are less than $2 billion against total insured deposits approaching $1 trillion. Near term (12 months) resolution costs are projected to be between $5-$6 billion, and anticipated income from regular assessments, special assessments, and portfolio earnings are estimated to be $2.5 billion for 1987. The financial picture is obviously more complex than this, given the existence of so-called secondary reserves which are counted as assets by both the FSLIC and the insured institutions. Another complication is the explosive growth of FSLIC guaranteed advances which currently stand at approximately $3 billion. The bottom line is that these numbers simply do not add up to a viable insurance alternative unless substantial new funds are injected within the next six to twelve months.

This being the case, the basic public policy question confronting the Congress is whether the shortfall in current FSLIC reserves should be made up by the healthy segment of the industry or the government itself. Good arguments exist on both sides of this question. Certainly the industry at large has benefitted over the years from a separate insurance fund. On the other hand, forcing the industry's healthy members to pay the liquidation costs of its weakest members (and former competitors) is to assign responsibility to institutions for circumstances over which they have no control.

The National Council was the first to suggest a solution somewhere in between——namely, a private/public partnership that would utilize the resources of the Federal Home Loan Banks as the lever for generating new funds for FSLIC. In testimony before the Congress two years ago, we outlined the following approach to FSLIC recapitalization:

> The most obvious and most readily implemented is for the FSLIC to borrow what it needs by establishing a standby line of credit with the Federal Home Loan Banks. The banks currently hold capital amounting to over $8 billion. They may be better able to carry the short term burden then are the individual thrift institutions. We recognize that the Federal Home Loan Banks are owned by the thrifts and that this idea would still reflect a cost to the industry; but, this may be an easier way to bear the burden.*

Unfortunately, this suggestion was not favorably received by either the FHLBB or the regional banks when we initially made it in early 1985. Instead, energy was expended on designing the Management Consignment Program and creating the Federal Asset Disposition Association. This is not to suggest these programs have not been of some assistance in easing FSLIC's problems, but neither are they a substitute for "real money" solutions.

Finally, in 1986 the Treasury Department, under the direction of Undersecretary George Gould, took the lead on this issue and developed a borrowing program premised on a capital contribution of up to $3 billion from the Federal Home Loan Banks. These funds would be used to establish a Financing Corporation which would support as much as $15 billion of capital market borrowings. Under the terms of the plan, these borrowings would then provide equity funds to FSLIC for use in disposing of failed institutions.

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* Hrgs. on Federal Regulation of Direct Investments by Savings and Loans and Banks; and Condition of the Federal Deposit Insurance Funds before the Subc. on Commerce, Consumer and Monetary Affairs of the H. Comm. on Gov. Operations, February 25, 1985, p. 169.

In response to objections by the Congressional Budget Office, the original plan was modified in order to avoid any budgetary impact by empowering the Financing Corporation to assess FSLIC-insured institutions to service its capital market debt, while FSLIC's assessment would be correspondingly reduced. In June, 1986, the National Council's Task Force studying this issue recommended support for the Treasury/FHLBB plan under the following conditions.

1. The legislation should provide that the 1/8 of one percent special assessment be phased out in equal increments in 5 years with FSLIC retention of its existing statutory authority to impose an assessment in future years if needed.
2. Market borrowings under the proposed program should be spread out over a period of years, so that funds are raised only as needed.
3. FSLIC should be directed to prepare a quarterly case resolution planning budget indicating prospective uses of funds to deal with problem institutions. This budget should be submitted for review to a special industry advisory committee composed of thrift institution executives.
4. Special consideration should be given to those bank districts where FDIC-insured thrifts own substantial amounts of FHLB stock.
5. There should be no barriers to the ability of depository institutions to shift between FDIC and FSLIC insurance.
6. FHLBB and FSLIC staff personnel should be removed from the restrictions imposed by the Office of Personnel Management in order to attract and retain high quality examiners.

Both the Treasury and the Congress were generally responsive to these suggestions when the bill was being debated last year. Amendments approved by both the House and Senate authorized a review board to meet quarterly for the purpose of advising on budgetary planning and prospective expenditure of the additional funds raised. Language was also included in the bill providing for a phase-out of the special assessment, although we note that this provision was deleted when the bill was reintroduced this year as S. 45. Finally, the capital contributions of the Boston and New York district banks, where most of the FDIC-insured thrifts are located, were appropriately adjusted.

On January 12, 1987, we reconvened our Task Force and, after considerable debate and examination of a number of different options, it was agreed that the Council should continue to support the Treasury/FHLBB plan. In fact, Mr. Chairman, because conditions at the FSLIC have materially worsened during the intervening months, we are now prepared to support immediate enactment of a FSLIC recapitalization measure regardless of whether our suggested improvements are addressed now or deferred for subsequent consideration.

We take this position because the indisputable fact is that in the absence of any new infusion of capital, FSLIC will be unable to deal with its current, let alone future, case resolutions. The anticipated cost of this effort is known to be at least $10 billion in 1987, with the eventual figure rising in fairly short order to $25 billion. This is not an amount which can be met through current and special assessments and earnings on reserves. Nor is it an amount which can be handled in a business-as-usual method. The clear message we would like to leave with the Committee today is that resolution costs have already been stretched out far too long and in too many cases.

The real risk of inaction is that the healthy sector of the thrift industry which I have described will be irreparably injured by the inability of the FSLIC to handle its current problems. We estimate, for example, that the cost of generating deposits as an FSLIC-insured thrift is approximately 50 basis points higher than the cost of raising liabilities for a similarly-situated FDIC-insured bank. This disparity is largely the result of the perceived weakness of the FSLIC fund.

Now, of course, the Congress has its own priorities, as do the regulatory agencies, the Administration, and other interest groups. Should the FSLIC recapitalization as introduced be unable to pass as a separate emergency measure, then, time permitting, we would likewise advocate some modifications. First on our list would be that some additional consideration given to the question of how the Bank Board will administer this up-front infusion of more than $15 billion in cash. The advisory board of industry representatives called for in the 1986 FSLIC recapitalization plan needs to be strengthened considerably in terms of both its composition and its mission.

Given the administrative burdens already facing the FHLBB as the chartering agency of federal thrifts, regulator of S&L holding companies and operator of the Federal Home Loan Mortgage Corporation, we suggest that perhaps the time has come to restructure the FSLIC more along the lines of the independent FDIC. For example, operating control over the monies raised by the Financing Corporation could be vested in a public/private board composed of diverse government officials. The FDIC, for example, has an employee of the Treasury, namely the Comptroller of the Currency, serving on its Board.

Another point which merits some consideration if the FSLIC plan is considered open for revision this year is the ability of institutions to convert from FSLIC to FDIC insurance—the so-called "Berlin Wall" issue. This issue first surfaced in May, 1986, when, at the request of the Congress, the Treasury submitted language prohibiting FDIC-insured institutions from membership in the FHLBB system. This amendment seemed to overlook the previously discussed fact that in the New York and Boston Federal Home Loan Bank districts, FDIC-insured thrifts constitute the majority shareholders of the Federal Home Loan Bank stock. Fortunately, this language was subsequently deleted from the FSLIC recapitalization bill, and other more onerous "Berlin Wall" amendments that surfaced during House consideration were likewise not adopted.

The National Council remains strongly of the view that current FSLIC problems in no way justify the reversal of 50 years of statutory authority which has permitted FDIC-insured thrifts to become members of the FHLBB; nor does it warrant the imposition of a prohibition or temporary moratorium on the ability of institutions to move from FSLIC to FDIC. On December 19, 1986, this issue was the subject of a court action in Florida, in which the District Court voided an "interpretive ruling" adopted by the FHLBB on October 7, 1986, stipulating that institutions must obtain Board approval before leaving the FSLIC system. The Court also took this occasion to comment on the recent practice of the Board to impose "exit penalties" equal to the present value of 10 years of insurance premiums on those institutions converting to FDIC insurance. The Court termed these exit premiums "extortion."

In the view of the Council, which participated as amicus curia in the Florida case, the clear state of the law on this point is that the Board is without statutory authority to reverse its long standing policy of permitting institutions to switch from FSLIC to FDIC insurance without paying any exit fee whatsoever. The National Housing Act does mention two years of continued premiums when an institution terminates FSLIC coverage, but this provision has never been interpreted to cover the replacement of FSLIC insurance with FDIC coverage.

We have likewise had a task force of affected institutions working on this issue and, notwithstanding the Board's long-standing administrative policy that no exit fee pertains when an institution remains within the federal deposit insurance system, we believe that given the current strains on the FSLIC fund, some reasonable exit fee is appropriate. At our Board of Directors meeting held on December 9, 1986, the National Council approved the position that institutions should be allowed to leave the FSLIC provided they pay an exit penalty equal to two years of regular premiums plus two years of special assessments. We further suggest that the authority to impose the two years premiums should terminate within five years as per the phase-out period for the special assessment included in last year's bill.

Adoption of this compromise would provide institutions in the marketplace with some degree of certainty both as to the cost and the timing of action on applications involving FSLIC to FDIC conversions. Especially in those states which are part of regional pacts or otherwise permit interstate banking, merger activity is proceeding apace and many of these transactions involve inter-industry acquisitions. Without the amendment we are suggesting, the industry will be confronted with the delays and costs of continued legal appeals, and the FHLBB will be deprived of any exit fees as was the case with two major transactions completed within the last several months.**

REGULATORS BILL

One of the other items of major banking legislation which was not passed last year was the so-called regulators bill which contains an extension of the emergency interstate acquisition authorities originally enacted as part of the Garn-St Germain Act of 1982. These provisions permitted both the FDIC and the FHLBB to merge failing institutions across state lines and further included a carefully structured bidding system with preference granted to in-state institutions and institutions of the "same type." The National Council strongly recommends that an extension for two years or, if the Congress is of the view, a permanent enactment of these so-called Title I authorities of the Garn-St Germain Act. Both the FDIC and the FHLBB have utilized this interstate merger authority sparingly and responsibly, and the cost savings to both insurance funds has been significant as a result of this added flexibility.

** Westchester Financial Corporation acquired by Marine Midland Bank of New York, and United First Federal Savings and Loan Association acquired by Barnett Banks of Florida.

The federal banking regulatory agencies have submitted as part of the regulators bill proposed language that would liberalize their emergency acquisition powers beyond that just described. This proposal has encountered opposition in some quarters and continues to be controversial insofar as the precise size of the bank which can be acquired on an emergency interstate basis. There has also been some question as to the branching rights of the acquiring institution in the state where the acquisition is made.

The National Council supported the regulators bill in the previous Congress, and notwithstanding some further liberalization at the state level, it continues to be our position that, at least on an interim basis, the regulators should have the authority to deal with institutions of all sizes in terms of attracting out-of-state bidders. With many of the problems in the commercial banking sector located in states which have historically been unit banking states, the threshold for emergency acquisition would certainly seem to be in need of some lowering if the bank regulators are truly to stay abreast of the size and nature of their current caseload.

The third major change in the so-called regulators bill would allow the FDIC to come to the aid of a bank this is "in danger of closing" as opposed to the requirement in current law that the institution be "a closed bank." The FDIC has had this authority for a number of years with respect to mutual savings banks; and, again, the record shows that this additional authority has not lent itself to administrative abuse. The "bridge bank" concept contained in the FDIC provisions of the regulators bill likewise represents, in our view, an important new tool for the FDIC to have at its disposal heading into what looks like another record year in terms of the number of commercial banks failing.

Another issue considered last year in the context of the regulators bill was the question of whether or not the FDIC and FSLIC should be subject to the Anti-Deficiency Act that allows OMB to set quarterly limits in expenditure of agency funds. Without even getting into the legal aspects of this dispute, we do not see how, as a practical matter, the deposit insurance agencies can be expected to discharge their responsibilities with this type of budget encumbrance. A crisis like the near failure of Continental Illinois Bank clearly demonstrates the need for maximum budgetary flexibility.

As a final comment on this aspect of today's hearing, especially insofar as the FHLBB is concerned, I would like to mention that interstate acquisitions are only one part of the answer to the current problems facing the FSLIC. We support the action of the FHLBB on April 24, 1986, to allow any company acquiring a failing thrift to branch or otherwise enter three additional states, and a number of institutions, notably First Nationwide and Carteret Savings Bank, have already moved to resolve problem cases on the basis of this new authority. It is our view, however, that the FHLBB needs to go further, and a first step would be to terminate its present policy which essentially precludes securities firms and insurance companies affiliated with securities firms from becoming acquirers of failing thrifts.

If Sears and Ford Motor Company are permitted to operate as savings and loan holding companies—which both companies have done quite

successfully—what public policy basis is there for precluding securities firms and insurance companies, both of which are primarily financial in nature, from acquiring failing thrifts? Reversal of the Board's policy in this area, we submit, would serve the purpose of bringing a substantial amount of outside capital and new management to the industry.

LOOPHOLE CLOSING

While Congress has been grappling with FSLIC recapitalization for two years, the question of nonbank banks has been before the Congress, not to mention the regulatory agencies and the courts, for at least five years. The consensus of how to deal with this highly-charged question has eluded the Congress, and this issue remains at the center of all banking bills considered over the last five years. We do not believe that this debate has been misplaced inasmuch as this issue goes to the very core of the separation between banking and commerce that has characterized our financial system in modern times.

By the same token, however, institutions have in some instances been operating nonbank banks for more than just five years. We would point out that during this period when we have witnessed a record number of commercial bank failures, including several of the largest and most prestigious banks in the country, and a record number of savings and loan failures, likewise including some of the largest institutions ever handled by the FSLIC, no problems of a supervisory nature have been encountered by the so-called nonbank banks.

The National Council approaches the nonbank bank question from the standpoint of its Statement of Principles which was developed when the

Council was formed by the combination of the National Association of Mutual Savings Banks and the National Savings and Loan League. These principles (Appendix A) specify that "The Council will not advocate restrictions on competitors, but will work to relieve restrictions on all depository institutions and thereby achieve competitive equity at the highest level." For this reason, the Council has not been actively involved in the nonbank bank debate. However, we have been vigilant to ensure that the operating powers of the thrift institutions which we represent are not curtailed under the guise of closing loopholes.

This question arises because previous attempts to redefine a bank have more often than not involved legislative efforts to define a "thrift." (_See_ S. 2851, 98th Congress, 2nd Session; S. 2592, 99th Congress, 2nd Session.) More specifically, these efforts have focused on a statutory formula mandating that thrift institutions hold in portfolio mortgage investments equal to 60 or 65 percent of their total assets. Mr. Chairman, I would like to express the National Council's unequivocal opposition to this so-called "thriftness test" which would respecialize thrift institutions at a time when the Congress should be further expanding the range of permissible investment activities for all depository institutions.

Mortgage finance has evolved into a integral part of the national and international capital markets. A host of new players are now in the morgtage market, including commercial banks, mortgage bankers, securities firms, insurance companies, credit unions, finance companies, and pension funds. We do not oppose the entry of this new competition to our

traditional business, but we must draw the line at the prospect of Congress dictating minimum investment formulas for our institutions while others retain the essential flexibility for management to determine the extent and timing of mortage investments.

The major problem with a thrift test is that market conditions vary widely across the country and change frequently. A reasonable test for institutions in one marketplace at one time may be prudently unattainable in another marketplace at another time. Largely on this basis, the concept of a uniform nationwide standard that would apply to 4,000 thrift institutions from Maine to California and everywhere in between has been specifically rejected in the past by both the Congress and the Federal Home Loan Bank Board.

In 1978 when Congress was first approving federal charters for savings banks, a specific amendment was offered during committee consideration in the House that would have required federal savings banks to invest 60 percent of their assets in mortgages. After considerable debate, the amendment was rejected by a recorded vote. In 1979, the Federal Home Loan Bank Board held a hearing on regulations to implement the federal chartering authority which included a reexamination of the feasibility of a 60 percent test. The Bank Board likewise rejected the approach as unworkable stating that:

> "a rigid quantitative home-financing test would prevent the Board from taking into account local circumstances and conditions." (44 _Federal Register_ 36015)

If an asset test made no sense five years ago when thrift institutions had the benefit of Regulation Q, not to mention an interest rate differential over commercial banks, how can it possibly make sense in 1987 when full deregulation of liabilities is in place. Particularly now that consumers have reasserted their preference for fixed rate mortgages, any statutory thrift test would consign our institutions, should interest rates rise, to a repeat of the portfolio losses that devastated the industry in the early 1980s. We urge this Committee in the strongest possible terms not to reinvent the Edsel which is what the thrift test really represents.

If I may suggest, Mr. Chairman, one person's loophole is frequently another's opportunity to expand and provide additional services in the financial arena. It may be recalled that when NOW accounts first started in the states of Massachusetts and New Hampshire, it was through a "loophole" in existing law which allowed state-chartered institutions to permit their customers to write checks on passbook accounts. Under the protection of former Senators Brooke and McIntyre, this loophole was legitimized in these two states and gradually expanded during the years in which you served as Chairman of this Committee, first to the rest of New England, next to New York and New Jersey, and then throughout the entire country in 1978. We well recall those who came before the Congress and urged that this loophole be shut down in the name of safety and soundness of the banking system.

You have also asked for our comments on the so-called South Dakota loophole, and, here again, we see evidence that what this effort really represents is one industry group seeking to erect barriers to the delivery of financial services by others. In this case, the so-called South Dakota language would take the limitations currently embodied in the Bank Holding Company Act and which are applicable, as a matter of current law, only to the nonbank bank subsidiaries of bank holding companies and extend these to bank subsidiaries.

While certainly not intended by its legislative sponsors, closing this loophole, Mr. Chairman, would have the effect of prohibiting savings banks in three states (Massachusetts, Connecticut, and New York) from offering Savings Bank Life Insurance (SBLI) which is consistently rated by Consumer Reports as the best buy in the insurance field (Appendix B). The National Council has over 300 members doing business in these states, and an increasing number of these institutions are forming holding companies and registering with the Federal Reserve Board.

It is frankly incomprehensible to us that the Congress or the Federal Reserve, in the name of closing loopholes, would take action to prohibit this consumer service which has been offered by savings banks since 1907 and which now provides approximately 1.5 million policy holders with over $16 billion of insurance benefits (Appendix C). The original and continuing purpose of SBLI was to ensure that low- and moderate-income families have an opportunity to purchase inexpensive life insurance. Louis Brandeis originated SBLI as an alternative to the high-cost insurance that was sold to working class families through insurance companies and agents. [See A. J. Mason, The Brandeis Way: A Case Study in the Workings of Democracy (1938)]. Cost to the consumer continues to be the principal marketing advantage of SBLI today.

There have also been indications from the securities industry that interpretations under current law such as the FDIC's ruling on the non-applicability of the Glass-Steagall Act to state-chartered non-member banks and the Fed's pending administrative proceeding on the "principally engaged" provision of the Glass-Steagall Act constitute additional loopholes which need to be closed. The National Council has savings bank members which have been offering securities services for over five years based on the FDIC's current interpretation of the law, and no problems have been encountered in this field at all. Savings and loan associations have utilized a similar ruling by the FHLBB to engage in the securities business individually and have also established a network called "Invest" which has a proven track record of providing discount brokerage and other low-cost securities services to a growing customer base.

In conclusion on this issue, several legislative proposals have been advanced in the name of closing loopholes that could have the effect of terminating these and other productive examples of increased consumer services that are critical to surviving in a deregulated environment. Thus we ask that the Congress move very cautiously if it is necessary to change current law in any of these areas.

We certainly support the efforts of the Federal Reserve to maintain the integrity of the payments system and the soundness of the federal deposit insurance system. However, we feel that these important public policy goals can be accomplished through holding company structure, appropriate safeguards on interaffiliate transactions, and increased supervisory action of individual institutions. The recent example of

Beneficial Corporation, which operates both a nonbank bank in Delaware and a federal savings bank in Florida, provides ample evidence that a financial holding company can encounter and meet problems in one aspect of its operations, namely, insurance, without these problems spilling over to its insured depository institutions.

INCREASED SECURITIES POWERS

I would now like to address the question of whether Congress should grant additional securities powers to banking organizations. Simply stated, the National Council supports expanded operating powers for all types of depository institutions. Here again, this is one of those questions which has been debated endlessly and which, due to Congressional inaction, has been largely left to the regulatory agencies and the courts. This is a time consuming and inefficient manner to go about the business of product deregulation.

In those areas which commercial banks and other depository institutions have been able to offer securities services such as discount brokerage, underwriting general obligations, and placing commercial paper, the market results have been one of increased competition and lower costs to users of these services. Among the securities services mentioned in the hearing notice, the one which is of principal interest to our members is the ability to underwrite and deal in mortgage backed securities. Some progress was made on this front as part of the 1986 tax bill through the enactment of so-called REMICS (Real Estate Mortgage Investment Conduits). Already we have seen a number of institutions move aggressively to bring issues of this type to the market, and we anticipate increased interest

Appendix C

Savings Bank Life Insurance
in effect as of November 30, 1986

NEW YORK

765,000 Policies

10.7 billion - Insurance in Force

MASSACHUSETTS

400,000 Policies

5 billion - Insurance in Force

CONNECTICUT

172,923 Policies

2.058 billion - Insurance in Force

The **Chairman**. Thank you, gentlemen. Thank you for two excellent statements.

I should announce that there will be 5 minutes allowed for questioning by each Senator.

CLOSING NONBANK BANK LOOPHOLE

Mr. Levy, yesterday Under Secretary Gould testified that Congress should move immediately to pass the administration's proposed FSLIC recapitalization plan but should do nothing about closing the nonbank bank loophole.

I note in contrast that you on page 10 of your submitted testimony say, "Any plan to recapitalize FSLIC may well fall short of its potential unless the nonbank bank loophole is immediately and permanently closed."

Can you explain to us why you believe that closing that loophole would, as you said, be essential to the FSLIC? Do you think a nonbank bank loophole closure should be part of any bill to recapitalize FSLIC?

Mr. **Levy**. We have taken a consistent position that the closing of the nonbank bank loophole is imperative. If we don't close the loophole, it is very clear that the costs of resolution are going to be sharply higher.

I was looking at the testimony that was presented yesterday by the Chairman of the Bank Board. On page 5 of his testimony, they provide a $9 billion contingency to deal with additional, now unknown contingencies if they develop. That's over and above $4 billion to deal with so-called borderline cases.

I question whether the Treasury plan and the $9 billion referred to might relate to just exactly what we're talking about. It is very clear that if we open the door and we cut down the value of entry rights, there isn't any question that the costs of resolutions can be sharply higher.

The **Chairman**. Thank you, Mr. Levy.

Mr. Gaiswinkler, Chairman Gray of the Home Loan Bank Board yesterday told the committee, "That it is important to the health of FSLIC to enact legislation to close the nonbank bank loophole." Mr. Levy, on behalf of the U.S. League makes the same point in his testimony today, as he just emphasized a minute ago.

I searched your testimony for any mention of the connection between the two and I didn't find any.

Do you agree with Chairman Gray and Mr. Levy that recapitalizing FSLIC would be cheaper and more successful if at the same time we closed the nonbank bank loophole and, if not, why not?

Mr. GAISWINKLER. Mr. Chairman, we have a philosophical proregulation stand which I think you understand. We have not taken part in any discussion nor are we taking a stand on the nonbank bank loophole. We feel that we do not want our savings institutions restrained in any way and, always accompanying—and I think this is one of our deepest concerns on the nonbank bank loophole—are other limitations attached to it like the thriftness test, Federal overriding State powers, and restriction on tandem sales. That is primarily what troubles us.

The CHAIRMAN. Mr. Levy, in yesterday's hearing Treasury Under Secretary Gould said that it would be very difficult to borrow $5 billion in the manner proposed by the U.S. League's FSLIC recapitalization plan. He said the interest rate assumption is too low. He said the amount of money to be borrowed is likely to be too high.

In addition, Federal Home Loan Bank Board Chairman Gray said that funds raised under the U.S. League plan would be inadequate to resolve the problems now burdening the FSLIC.

Do you have any comment on these criticisms made by these two regulators?

Mr. LEVY. Mr. Chairman, I would not take issue with the Under Secretary of the Treasury when it comes to dealing with the issuance of bonds in the public marketplace.

I would say this. We are committed to a plan that would bring those bonds to market at the lowest cost. If our mechanism isn't the one to be used, we would be happy to look at alternatives and we don't challenge the form of the mechanism. We don't think that's the issue. We think the issue here is the amount of dollars being committed and the timeframe.

Once again, on the question of the differences in dollars, you raised the point made by Chairman Gray, the need for the additional money. The difference between the two plans is $10 billion in bonding and I point again to the Chairman's own statement where they have built in a $9 billion contingency for unknowns. We agree, it is terribly unknown. This whole economic depressed area problem could change. It could get worse. It could get better in the 2 years. We think Congress should retain the right to review this situation 2 years down the road and that we shouldn't hang out $9 billion contingencies.

We think that that's probably the essential difference between the two plans. We do not take issue with the mechanics of raising the money.

The CHAIRMAN. Mr. Levy, Treasury argues that even if insolvent thrifts close following the FSLIC recapitalization bill the remainder of the industry will still be grossly undercapitalized and that there is no way the industry can raise the capital by itself.

The Treasury solution is to liberalize our laws to allow commercial and industrial firms to own thrifts.

Can you comment on the Treasury proposal?

Mr. LEVY. Yes, I can comment. Now, 77 percent of the institutions, virtually the same number that my colleague, Mr. Gaiswinkler refers to, of savings and loans are earning at near record levels, close to 1 percent return on the assets. That's the old-fashioned way to build capital. We have had a slowdown in the growth in assets and we have had a tremendous increase on the part of four out of five institutions on the basis of earnings and I would say we are building capital.

CAPITAL LEVELS GOING UP

Our capital levels are going up. The problem lies with institutions that are located in the States designated in green on that map. When we talk about $6 million a day in losses, yes, we don't quarrel with that. But one must recognize that a lot of that loss is coming from writedown and marking of real estate in those areas to market. And it gets into the whole discussion of the kind of appraisal standards and guidelines that are being used.

If you had marked all of the financial industry—the savings banks and savings and loans—to market in 1981 or 1982, we would have all shown negative statements and we have all come back with strong earnings, and we have recovered.

What we're saying here is: Yes, if you mark those areas to market at this time at near the bottom of the real estate market, without question you are going to generate all kinds of losses. But those losses are being taken first against the reserves if they're there in those institutions, and ultimately against FSLIC. But these are not ongoing losses. A good bit of that $6 million a day represents recalculating values and writedowns against the capital of those institutions because of changed real estate conditions.

The CHAIRMAN. Thank you, Mr. Levy.

Senator Garn.

Senator GARN. Mr. Levy, in response to Senator Proxmire's question and also your testimony, you favor closing the nonbank bank loophole. How?

Mr. LEVY. With your support and the support of others.

Senator GARN. Well, no, I'm being specific. It's easy to say we're in favor of closing a loophole. Specifically, how do you want to close it and what kind of a grandfather date are you talking about?

Mr. LEVY. Well, we've had little problem with the proposals that have been on the table. We have supported them and we understand that, as time goes on and we move further from these grandfather dates, it's very difficult to move backward, we understand the opposition. When I read the Treasury release on Tuesday afternoon and understand that they now stand squarely behind it, I understand the problems that we face in that area.

And I say from our standpoint we haven't seen action. The bottom line to it all is we believe that if it isn't addressed the costs are going to be greater to the people who pay and in this case the people who pay are not the taxpayers; the people who pay are going to be the savings and loans that are the healthy savings and loans in this country.

Senator **Garn**. Well, I understand your principle. What I'm getting at are the practicalities of it. We had a nonbank bank loophole closure in my bill that passed the Senate in 1984. It's now 1987. So what do you do? Date of enactment? Try to back it up? Is it fair if you have date of enactment to say, "OK, everybody who has one gets one." That would be a nice situation. I'd love to be a nonbank bank and say, "OK, we stop today. Nobody else can have them but I've got mine."

What I am saying, trying to pin you down, is that it's easy to say you're in favor of closing the loophole, but I'm trying to pin you down and say how, and how, do you address these issues? What's fair and what's not fair?

Mr. **Levy**. I don't want to be flip in a response and I would prefer to have the opportunity to present that in writing to you later.

Senator **Garn**. Well, no, that isn't a flippant response, but it is a difficult question. It's not a new one. It's been going on for a long, long time and I think you're well aware of my opinion. I've been in favor of closing it but never in isolation. That's one thing I would say, that when I've listened to testimony now for 12 years, it's easy to be for something without addressing the difficulties of how to get from here to there, and once again, the thing that bothers me frankly, coming from the savings institutions, is you always seem to get hung up on one issue that's going to save you and I go back to regulation Q. I can remember when the savings and loan institutions were willing to sell their wives, their mothers, their children and everything to keep that one-quarter of 1 percent. And all these dire consequences would take place. The world would come to an end if that ever happened.

Well, it happened and none of those dire consequences took place because of one-quarter of 1 percent.

Now we're hung up on a nonbank bank loophole and I wish I could get you to look at the broader picture of the whole internationalization of the capital markets and if we closed the nonbank bank loophole tomorrow with a retroactive date back to July 1, 1983, which Chairman St Germain and I felt was magic at the time, you're still going to have problems in the savings and loan industry.

So I'm trying to get you to look at a broader picture rather than focus on some bogeyman here that isn't the total source of the problem. The marketplace is changing dramatically and faster every day and we've got to do more than just close the nonbank bank loophole.

So I'm hopeful when you respond in writing we can have more than just "We're in favor of it." I know that. There's no doubt in my mind. I knew that before you testified. You want the nonbank bank loophole closed, but we need more specifics than that. How? And how are we going to address some of these other issues?

Sometimes I'd like to just go ahead and surrender and say, "OK, let's close it; let's not do anything else; close it," because I'd almost like to be able to say to everybody, "I told you so. It didn't solve all the problems." It isn't magic. We've got to learn that and start taking a broader comprehensive look at these changes in the financial markets more than just a South Dakota loophole closure and a nonbank bank loophole closure. That's all Congress has done essentially for the last 20 years is play little games and put your finger in the dike type of thing.

Well, you've listened to me, too, for all these years and I haven't changed either. I'm still going to try and push for a broader view as the marketplace continues to change and we shouldn't legislate by loophole closures alone.

The FSLIC recapitalization plan proposed by the Treasury requires a contribution of $3 billion from the Federal Home Loan banks as collateral on the debt to be issued by the financial corporation. Does the Treasury plan contemplate the repayment of this $3 billion to the Federal Home Loan banks, Mr. Levy?

Mr. LEVY. I think they do contemplate over the 25- or 30-year period that eventually the money could be repaid.

Senator GARN. And the plan proposed by the U.S. League does not require the contribution of $3 billion. Do you feel then that the U.S. League plan places less of a strain on the Federal Home Loan Bank system?

Mr. LEVY. Well, the U.S. League plan is based on the 20 percent of the earnings of the bank system. If the bank system earnings are insufficient, the savings and loans would stand behind it and would fund any shortfall. So we don't feel we're placing an undue burden because it is limited to actual earnout.

Senator GARN. Thank you.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its oversight hearings on banking issues that have carried over from the 99th Congress. We have a distinguished group of witnesses before the committee today representing State governments, the thrift industry, and the banking industry. I look forward to hearing their testimony.

As I stated yesterday, I believe the committee should attempt to act quickly on all the issues we failed to resolve in the last Congress. We must act on FSLIC recapitalization, on the issues addressed by the so-called regulators bill, on the nonbank bank and South Dakota loophole questions, and on expansion of bank asset powers. It would also be desirable to reach an early consensus on the check hold issue.

I am not convinced, however, that the best way to achieve enactment of legislation in each of these issue areas is to combine them into a single, omnibus bill. We have tried that in each of the last two Congresses, and the result has been that we have not made any progress on any of these issues.

I am particularly concerned about the FSLIC issue. I do not think we can afford to delay action on recapitalization any longer. I believe Congress made a real mistake by not enacting legislation in this area last year. I understand that there are some differences of opinion on how best to handle the recapitalization, and I believe the committee should consider all alternatives very carefully. The bottom line, however, is that we must enact recapitalization legislation before summer. Frankly, I'm not sure we can afford to wait that long.

Further, it is worth keeping in mind that the jurisdictional situation in the House is more complicated than it is in the Senate. Bank asset powers, for example, will likely have to be considered by two House committees, Energy and Commerce, and Banking. This will inevitably lead to some delay.

I believe we should craft legislation in a way that will maximize the chances of success. However, I hope we will not create a legislative "hostage" situation that will make it more difficult to make progress in those areas where we can make progress.

I think this committee should press hard for action on the entire financial services agenda, but we must be practical enough to seize the opportunities to achieve at least partial successes. The alternative is to risk a third Congress with no measurable progress on any of the major issues facing us.

The **CHAIRMAN**. Senator Graham.

Senator **GRAHAM**. Thank you, Mr. Chairman.

I would like to ask the same question of each of the panelists and that is: What is your diagnosis of the elements that have brought us to the current situation with FSLIC?

Mr. **GAISWINKLER**. There's a million of them but I can give you a couple of them.

Senator **GRAHAM**. Give me what you think are the top five.

REASONS FOR THE FSLIC PROBLEM

Mr. **GAISWINKLER**. Primarily it started back when we deregulated the liability side of the balance sheet and we did not deregulate the asset side.

In 1980-81 interest rates skyrocketed and some of the associations were so severely damaged they could not make a comeback. There were those who tried to make a comeback and didn't do it prudently, they reached out and took a lot of chances. That is primarily the reason why we have that problem.

Another major contributer to that was the fact of the economic conditions, as the U.S. League has stated and I referred to in my testimony, in the agricultural States and in the oil States. This economic problem has created just absolute havoc to real estate values and contributing also to that are the writedown of net worth as a result of those real estate problems. All these factors have caused savings and loans to be in a severe condition.

In addition to that, as in all industries, we have our crooks and so forth and they caused a lot of problems too.

Mr. **LEVY**. Senator, there really are two problems that the FSLIC has had to face. One is the fallout from the interest spread problems of the early 1980's and the second are the asset quality problems that we're experiencing today.

As deregulation came on, institutions virtually had no capital standards to meet. This means that instead of being able to leverage up to size 33 to 1, in fact there were periods there when you could leverage an institution up to almost infinity. And it didn't should Congress expand the ability of thrift institutions to deal directly in mortgage backed securities.

Over the last several years, expanded securities powers have been discussed in a context of banks and thrifts establishing holding company subsidiaries in order to engage in this activity. This approach has been advocated by Treasury and others as a means of insulating the new activities from the insured institution and achieving a greater degree of regulatory parity. The National Council supports the holding company approach, provided that mutual institutions are not precluded from taking advantage of these new powers. This Committee addressed this question when approving securities powers in its 1984 and 1986 legislative proposals through the authorization of mutual holding companies. We urge the Committee to include a similar provision in any legislation dealing with this subject that emerges from this year.

FUNDS AVAILABILITY

Another issue to which the Congress has devoted considerable attention is access by the consumer to checks deposited for collection. So-called funds availability legislation in one form or another has passed both the House and the Senate but has not made it through to final enactment, as has been the case with many other bills that we have discussed today.

While this subject has been debated at the Federal level, numerous staes have enacted funds availability statutes, including such major banking states as New York and California. Because of this action at the state level, the National Council suggests that two of the major

considerations in taking up this bill this year should be the coordination with state law and improvements for returning dishonored checks through the payment system. Previous federal legislation on this subject has generally taken the position that where state standards are stricter, state law shall prevail and apply to both state- and federally-chartered institutions. The National Council certainly does not oppose reasonable check hold legislation at the federal level, to include uniform disclosure standards and reasonable compliance requirements. However, we believe that the interaction with state law has not been appropriately addressed in any of the bills we have seen to date.

We suggest that the overriding need for promoting and improving the national payments system will sooner or later lead us to the point where uniform federal standards are going to have to prevail. This approach would also avoid the difficult question of applying requirements of state law to federally-chartered institutions which would entail disturbing precedents that have governed the banking system insofar as national banks and federally-chartered S&Ls are concerned for 100 and 50 years, respectively.

Insofar as the particulars of federal legislation is concerned, the Council finds that the measures passed last year by both the House (H.R. 2443) and the Senate (S. 1841) are essentially workable bills. The important features which should be retained in any version of this legislation adopted this year are the exceptions for transaction accounts opened for less than thirty days, deposited checks in excess of $5,000, and any account on which the customer has repeated overdraft problems. As mentioned, the handling of returned items also needs to be addressed in any bill this year.

CONCLUSION

While we appreciate the opportunity to testify on a broad range of subjects today, the essential thrust of our remarks is that the declining state of FSLIC's finances constitutes a problem of major proportions which requires immediate steps to rectify. The time for debating the precise structure, let alone the fine points of the program, has long since passed. We urge this Committee to support the Treasury/FHLBB plan and bring this matter before the full Senate as soon as possible. We hope that House concurrence will follow shortly thereafter.

I would be very pleased to answer any questions which the Committee members have at this time.

Appendix A

National Council of Savings Institutions

Statement of General Principles

The National Council of Savings Institutions is dedicated to the principle that depository institutions should be able to compete effectively and fairly in the rapidly changing financial services marketplace as it exists today and as it evolves in the future.

The Council recognizes the revolutionary changes which have occurred in consumer and business demands for financial services. Today's customers expect: a market rate return on their savings and transaction accounts; ease of access to their funds; and, flexibility in allocating these funds among different investment media. They also demand convenience and efficiency in meeting their housing, personal business and other credit needs. Savings institutions should be able to provide a complete range of services to meet these demands.

The Council will work vigorously for the creation of a legislative and regulatory climate which will enable savings institutions to serve this market. It will work for further deregulation of product and geographic restrictions which inhibit the ability of savings institutions to compete. The Council will not advocate restrictions on competitors, but will work to relieve restrictions on all depository institutions and thereby achieve competitive equity at the highest level.

The Council recognizes that savings institutions will pursue different strategies to meet increased competition in the marketplace. Some will choose to expand in their immediate market area, while others will operate on a regional, national and even international basis. Some will wish to broaden products and services, while others will choose to specialize.

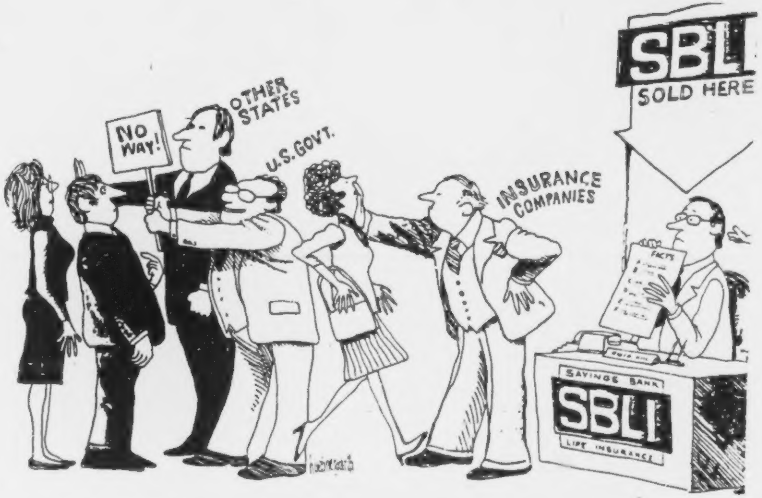
The Council will work to develop public policies which will enhance this freedom of choice—including meaningful regulatory alternatives. Traditionally, an institution's charter predetermines its approach to business. Today, market area, market demands, management experties and regulatory distinctions are key factors in determining business directions. Acknowledging the varied missions of savings institutions, the Council will stress flexibility and charter options as needed by the industry.

The Council is cognizant, and recent times have amply demonstrated, that a strong capital base is essential for an institution to survive the vagaries of the financial markets and to position itself to keep up with changing consumer needs and other financial demands. Therefore all legislative and regulatory issues must also be considered from the standpoint of their effect on profitability of institutions. Access to the capital markets is also critical for the continued safety and soundness of financial institutions and the sanctity of the federal deposit insurance funds.

The Council will work to complete the process of evolution enabling savings institutions to participate fully in the marketplace of the future and to provide consumers and other customers will the full range of financial services.

THE BEST LIFE INSURANCE MONEY CAN'T BUY

Want to buy good coverage at low cost? You'll have to move to Massachusetts, Connecticut, or New York where SBLI is the answer to high-priced protection.



If you live or work in Massachusetts, Connecticut, or New York, you can count yourself lucky when it comes time to buy life insurance. But if you live in any other state, you may want to do some insurance lobbying. Why? Because unless you live in one of these three states, your money can't buy the best life insurance available.

The state laws in those three states empower mutual savings banks to sell life insurance—over the counter, directly to the customer, with no agent's commissions. This means great savings which are well worth going after if you have access to them. Unfortunately, since those banks operate under state laws, only people who live or work in those states are legally eligible to buy this insurance.

For most people, life insurance is at best a grim subject or a necessary evil, but it's not a subject to be ignored. Policies are not all alike and anyone who believes they are is in for a rude awakening. Consider the following comparison.

Bill and Barry are both 35 years old and in good health.

- Bill buys $25,000 in term life insurance—five-year renewable term that earns generous dividends. Exclusive of the dividends, his annual premium is $62 a year.
- Barry also buys $25,000 in five-year renewable term insurance. His policy also participates in dividends, though not as high as those Bill will earn. Nonetheless, Barry pays an annual premium of $144 a year.

Why? Is it that Barry has heart trouble? Does Bill have an uncle in the business? Or did Bill buy an inferior, but cheaper, policy? The answer is none of the above. Bill got a better deal for one reason—he lives in Massachusetts and bought his coverage from a savings bank.

Why are residents and workers in New York, Connecticut, and Massachusetts favored with no-agent life insurance? It all began in 1907 when Louis Dembitz Brandeis, who was to become an Associate Justice of the United States Supreme Court, saw the need for low-cost life insurance.

Furthermore, he realized that a network of savings banks—which served the banking needs of the poor as well as the more affluent—already existed in Massachusetts, where he then lived and practiced law. Matching the need with the already existing structure for fulfilling it, Brandeis succeeded in getting legislation passed that would allow people to purchase life insurance at low cost through those banks. New York followed suit in 1938, and Connecticut did so in 1941.

Limitations

The long-term results would both please and displease the late Justice. Savings Bank Life Insurance, or SBLI, is indeed low-cost. In fact, it is unquestionably the best buy in life insurance available in the United States, except for a few tax-sheltered policies offered by the Teachers Insurance and Annuity Association, which are available only to people in certain jobs.

There are, however, three unfortunate aspects of SBLI about which its own officials are keenly aware:

1. It is available only to those in a small geographical area.
2. It is limited in amount. In Massachusetts, the maximum that can be sold to any one person is set by law at $53,000 in face value. The amount in New York is $30,000, and in Connecticut it is $20,000.
3. It does not attract those the late Justice Brandeis most wanted to reach. The poor and the uninitiated often are still the victims of high-pressure salespersons who promote the most expensive types of insurance. In low-rent districts, the ubiquitous debit-man who represents the commercial company still trudges the streets collecting dollars by the week for burial insurance.

Who Buys and Why?

Well-informed consumers in Massachusetts, New York, and Connecticut buy SBLI, at least as the basic foundation of their insurance programs. Reading a printout of who has bought new SBLI policies is revealing. Time after time, the occupations listed reflect a degree of sophistication—doctor, dentist, attorney, engineer, teacher, manager, and so on.

Not that SBLI people don't want to sell policies to those in less lucrative positions. They do indeed. But the fact is, their sales efforts are essentially limited to advertising, since the banks are forbidden by law to have salespersons physically working outside of the bank building. As a rule, this means the word about SBLI gets out to only the more discriminating consumers who tend to be willing to read and evaluate no-nonsense advertising.

By way of contrast to another area of consumer concern, it's worth remembering that in May, 1968, the President signed into law the Consumer Credit Protection Act, commonly called the "Truth-in-Lending Law." Basically, this act required lenders to disclose, both in advertising and on loan forms, the actual cost of borrowing money both in total dollars and with a standardized figure known as the "annual percentage rate." This gave borrowers the ability to shop for loans and make easy cost comparisons.

The problem is life insurance buyers have no such protection and could definitely use it. Except for SBLI, really factual advertising that clearly compares costs and benefits is hard to come by. Methods of computing costs or earnings on permanent life insurance are confusing.

The Federal Trade Commission has urged some reforms that would help buyers to discriminate between good and bad life insurance buys. In a controversial staff report issued in 1979, the FTC suggested adoption of an actuarial method called the "Linton yield" as a standard of measurement of the interest rate of the average annual return of the cash-value portion of an ordinary life policy. The Linton yield, developed by an outstanding actuary, gives policies the hard scrutiny they deserve.

Interestingly enough, the only company in the country that routinely discloses the Linton yield on its policies is Massa-

Connecticut
New York
Massachusetts

chusetts SBLI. Perhaps this is because its Linton yield averages are consistently high. In 1977, according to the FTC, the industry's average return was 1.3 percent. Massachusetts SBLI, on the other hand, averaged over 7 percent.

Insurance Sales Myths and Facts

Part of the problem in getting SBLI to catch on nationwide goes back to some long-standing and popular beliefs shared by many life insurance agents.

- "You can't sell death insurance; you must sell life insurance." What this translates into is that much cash-value type insurance, usually called whole, straight, or ordinary life, is sold as a savings plan with the death benefits downplayed. "You'll earn a fortune in your lifetime," goes a classic pitch, "but how much of it will be yours to keep?" A sales talk follows that emphasizes any plan ranging from an endowment to ordinary life, depending on how large a premium the salesperson figures the prospect can afford.
- "You can't sell insurance over the counter." In the first place, people will respond *only* to an emotional appeal. In the second place, if you offered it over the counter, you'd get a bad statistical spread—only bad-health risks would apply.
- "Over-the-counter sales would not produce sufficient volume to give the issuing company financial stability."

Seventy-plus years of SBLI experience have effectively disproved each of these beliefs. Using data from Massachusetts SBLI as an example, here are the facts:

- Most SBLI plans stress protection over savings—that is, term insurance over ordinary life. Every type of plan from endowments on down in price is available; but the big advertising impact is on such things as the new, very low-cost $50,000 "Non-Smokers Policy," which would, obviously, use up all but $3000 of the $53,000 limit per insured, and would not be the sort of policy that an agent, dependent on sales commissions, would be likely to stress. There's little emotionalism in SBLI advertising. In fact, it's so factual that it tends to be dull!
- You can sell insurance over the counter. Again, strictly in Massachusetts, at the end of 1979, there was over $2.7 billion of SBLI in force in over 850,000 policies. In a state with a population of less than 6 million, that's an impressive percentage! And, if you add in New York and Connecticut, a total of over $10 billion in SBLI is in force. The fact is, people *will* buy life insurance over the counter, if it is available.
- In answer to the objection that over-the-counter sales might attract deathbed cases, it should be understood that you can't simply walk into any savings bank and buy SBLI. You must pass rigorous physical requirements, and on much lower policy limits than most commercial companies require. SBLI is highly selective.

Why SBLI?

Here is a summary of the advantages of SBLI:

1. Low cost: SBLI is usually the best buy around.
2. There is little or no sales pressure because there are no agents trying to earn commissions. This also figures into the low cost.

A typical agency commission schedule goes something like this: 55 percent of your first-year premium goes towards the agent's commission; in the second through fifth years, 10 percent of what you pay goes to the agent, and in the sixth through tenth years, 5 percent. On a typical $25,000 commercial ordinary life policy issued at age 35, the premium might be, on the average, about $450 (as opposed to $350 for a similar Massachusetts SBLI policy). This means that the first year's commission is a whopping $247.50 as opposed to an average of $54 a year over a ten-year period. Clearly, the incentive is for the salesperson to concentrate on new business instead of serving existing customers.

3. Massachusetts SBLI begins paying dividends—and they are about the highest in the country—starting with the first anniversary of the policy.
4. Cash and loan values begin on all level-premium, permanent policies after one year.
5. SBLI offers just about every coverage available from commercial companies.

The conclusions are obvious. For persons residing or working in an SBLI state, the smart money move is to buy any permanent insurance desired through SBLI, then round off with SBLI term, adding commercial term only in those cases where SBLI limits don't meet the needs of the insured.

Actually, the $53,000 maximum is a lot of insurance for most people, if you consider the huge insurance feature of Social Security plus the employee group plans that include so many consumers.

WHAT YOU CAN DO

Here's a bit of consumer advice. If you can ever qualify for SBLI, buy it. If your son or daughter ever goes to school or has a job in Massachusetts, New York, or Connecticut, grab a policy for him or her while you can. It will remain in force after the person leaves, for as long as premiums are paid.

In the meantime, write to your representatives in the state legislature and Congress. You might even try your state insurance commissioner. And urge your local bank and savings institution to try to get enabling legislation passed. Lobbying takes time, but if it succeeds, everyone will benefit.

1. As a consumer, you will benefit from lower rates.
2. You will also benefit from much more impartial financial advice. A salesperson will often go for the highest premium and not necessarily the most appropriate coverage.

Your community will benefit from an influx of long-term investment dollars that will end up primarily in first-rate local home mortgages.

4. Your bank or savings institution will benefit from an important source of business.

If trying for bank related low-cost life insurance seems like a futile effort, consider this: Just about ten years ago, because one assertive savings banker in Massachusetts demanded the right to receive interest on personal checking-type accounts, fought the case in the courts, and won, beginning this fall, consumers all over the country will be sharing in the benefits of his efforts. NOW accounts, as they are called, will be a nationwide reality.

SBLI, or its equivalent, can also expand to the other 47 states. All that's needed to make it happen is consumer activism, backed by a strong demand for the product.

Low-Cost Alternatives

But how about everyone living and working in other states? Even if you phone an insurance company and initiate the sale yourself, you pay precisely the same high sales commission as the prospect who must be chased and wooed and pressured for weeks.

There are some possible alternatives which, if initiated, could save consumers all over the country money on life insurance policies.

Use existing facilities to offer lower-rate insurance than is currently available. This might be done, for instance, through a network such as the Allstate booths already located in Sears stores all over the country.

Expand existing SBLI. Current Massachusetts and New York laws forbid their organizations to operate beyond state lines, but Connecticut SBLI is chartered as a commercial company and, technically, could expand into any state that passed enabling legislation. Thus, if state-chartered savings and loan associations in Ohio, for example, wished to go into the SBLI business and the Ohio legislature authorized it, they could do so under the sponsorship of the Connecticut SBLI organization—thus saving enormous expense in setup costs.

Pass appropriate Federal legislation so that Federal savings and loan associations and even national banks could establish bank-sponsored life insurance programs.

Establish a new breed of banks, such as Federal mutual savings banks. This is probably the most likely bet of all. In an attempt to broaden the lending and checking powers of savings and loan associations, it is likely that Congress will authorize some S&Ls to switch to a Federal mutual savings bank charter. If this happens, perhaps SBLI will come into being on a national basis.

The odds remain tough, though. The insurance industry would fight it with every means at its disposal, and that's a lot of means. But smart bankers might well see it as a source of long-term dollars much needed for mortgage loans.

Sell over the counter life insurance through a commercial company. If just one national, reputable insurance company would say, in effect, "Okay, let's have a go at it," and would establish walk-in offices, spend money on educational advertising rather than sales commissions, and look for quality risks and other lower cost factors, it might shunk the industry.

Over 350 banks selling SBLIs in the three states have proven that intelligent and informed consumers *will* walk in the door and buy life insurance. Consumers are getting smarter every day, and any company that bets a lot of dollars on the opposite premise is going to suffer in the long run.

From the standpoint of consumer activism, a problem exists in getting many people to protest or combat high life insurance costs. The people most justified in getting upset are those who have already been overcharged, and they would stand to lose even more if they switched policies as a means of protesting. In most cases, it just doesn't pay to buy life insurance policies repeatedly—you buy one and hold it for the long term.

By Donald R. German. Co-author of 14 books in the field of banking and finance (Warren, Gorham and Lamont, Inc.), regular contributing editor to three retail banking newsletters.

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take long for shrewd developers and people outside the financial field to recognize the potential. They moved in quickly and as it turned out, in many of the States shown in green which were the high-growth areas in the mid-1980's and the 1982–84 period in the Sunbelt areas; they were able to grow at astronomical levels.

The industry as a whole in 1983–84 grew at a compounded rate of almost 20 percent a year and attracted enormous amounts of funds, brokered deposits, little or no capital. The tax laws were driving development of real estate way beyond market demand and we had a situation where we had an enormous amount of money pouring in, going into development in areas that were showing signs of high growth. Then, of course, we had a screeching halt with the energy problems, with the agricultural problems, and now we sit looking at all of this asset quality and the writedown of assets in that area and the impact that it's having on the fund itself.

Senator **Graham**. If I could restate the last comment of Mr. Levy, it seems to me that what we've had is a system which privatized and encouraged profit-seeking activities and then socialized the losses when those ventures did not turn out. We are now looking at the cost of socializing some of those losses.

My question is, as we accept this immediate palliative to deal with the current problems, what are the longer range proscriptions that you would recommend be incorporated in addition to the nonbank bank issue that would keep us from being in this situation 5 years from now?

TOUGHER ENFORCEMENT OF STANDARDS

Mr. **Levy**. Well, I would underscore that I think that we are still privatizing the fallout. We used to say that savings and loans bet the bank. If they were right they were heroes. If they lost, the FSLIC would pick up the tab. That isn't the case. We have amended that now. It's not the FSLIC. It's the savings and loans that pick up the tab because uniquely we are paying for that.

Much has been done by Chairman Gray to stop the process that I talked about. He really stopped the growth business with new standards and limitations on growth that went into effect at the start of 1985 and we're back down to 6, 7, or 8 percent growth levels.

No. 2, he's brought in much tougher capital standards which are absolutely needed. The whole supervision and examination function has been greatly strengthened so that we can get an earlier detection of problems coming forth.

I think the atmosphere has changed. We don't need new laws, new regulations. What we needed was just stiffer and tougher enforcement of what was there and the Bank Board has moved in and I think Chairman Gray has performed admirably in following through on that. If they haven't capped the problem, they are very close to getting the kind of people to clean our business out.

Mr. **Gaiswinkler**. Senator, I concur with that except I think that it could have been done earlier.

Senator GRAHAM. My time has expired. The summary is that you do not feel any further legislative action is necessary to support the administrative steps which are currently underway?

Mr. LEVY. That's correct.

Mr. GAISWINKLER. Yes.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman. Mr. Chairman, I would first ask permission to submit a statement for the record.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. This is the second in 3 days of hearings during which the committee will examine the issues related to the closing of the nonbank bank and South Dakota loopholes, the recapitalization of the FSLIC fund, the so-called regulators' bill, check-hold legislation and the expansion of bank powers into security underwriting. I expect that this hearing and the one to follow will prove as informative as yesterday's. I am glad that the chairman has decided to air the many matters requiring immediate legislative action, such as the recapitalization of the FSLIC fund, as well as those requiring more deliberation, such as the question of bank securities powers.

Before we begin this morning's hearings, I believe a review of yesterday's proceeding is in order.

Yesterday's hearing record revealed an uncharacteristic degree of unanimity between our witnesses. First, they all agreed that FSLIC recapitalization should be our highest priority followed closely by prompt consideration and passage of the regulators' bill. They also agreed that, of the various FSLIC recapitalization proposals under active consideration by the committee, the Treasury proposal would provide the soundest method of recapitalizing the FSLIC fund. With his usual verve, Undersecretary Gould made a convincing argument in support of the Treasury proposal while criticizing the proposal advanced by the U.S. League. In the interest of fairness, I am glad to see that the League will have the opportunity to rebut the criticism leveled at their proposal by Undersecretary Gould, FHLBB Chairman Gray, Comptroller Clarke, and FDIC Chairman Seidman.

Second, the witnesses were in agreement that immediate action should be taken with regard to the regulators' bill and, to a lesser degree, check hold legislation.

Third, the witnesses also suggested that the nonbank bank and bank powers issues needed resolution at some point during this Congress. Noting the concern expressed by members of moving too precipitously in this area and echoing many of the opening remarks of my colleagues, the witnesses did not place as high a priority on the resolution of these issues.

Finally, we learned that commercial banks as well as a vast majority of the thrift industry are healthy and in some instances enjoying record profits. Chairman Volcker also informed us that we are not falling behind our international competitors in the area of banking and finance. He informed us that in the arena of international banking and finance, U.S. institutions are positioned on the "cutting edge" of the industry. His remarks regarding the emergence of the Japanese and French banks as the largest banks in the world were attributable to the nature of their banking systems rather than a competitive advantage.

The assurances of the health and international competitiveness of the commercial banking system are of great interest to me because those wishing to grant banks additional powers cite the loss of profitability and an inability to compete internationally as the reasons to tear down the walls between commercial and investment banking.

I also note with great interest Chairman Proxmire's desire to close the nonbank bank loophole because of his burning passion to keep commerce and banking separate. He echoes Chairman Volcker's warning that an increasing concentration of financial and commercial power would not be in the best interest of this country's economic and financial system. Granting banks the ability to engage in investment activity permits the wall between banking and commerce to be broken down from the other side. Securities underwriting combined with traditional banking functions will permit a concentration of financial and economic power that totally eclipses the potential for concentration presented by the nonbank bank loophole.

Finally, I do not think that we can let the structure of the marketplace today dictate the terms and conditions of the legislation that we must consider to regulate our financial institutions and market. Neither can we permit bank regulators to accomplish by administrative fiat what we are entrusted to do by our positions as elected officials. We must enact laws which dictate to the marketplace how it should be structured to ensure the safety and soundness of our financial system. It is not the regulator's role to usurp this function from us. They must enforce the laws that are on the books rather than accommodate certain institutions which seek inventive ways to circumvent existing statutory requirements.

I realize that the financial world is changing and that a congressional response to these circumstances is required. However, I am concerned that we do not sacrifice the safety and soundness of our financial system and investor protection upon the altar of market efficiency.

I look forward to the testimony of this morning's witnesses and hope that their statements will provide us with the information that we require in making our decisions in the upcoming session.

Mr. Levy, I noticed that you support the recapitalization plan that's been put forth by the League, but I detected in the questions put to you that is if you had your druthers, but you're really calling for speedy action with respect to the recapitalization. Is that correct?

Mr. LEVY. Yes, we support a recapitalization plan.

Senator D'AMATO. In other words, you have your own plan and the plan proposed for the U.S. League, is that right?

Mr. LEVY. Exactly.

Senator D'AMATO. As opposed to the Treasury plan?

Mr. LEVY. Exactly.

Senator D'AMATO. But I gather in the tenor of some of your responses to questions that were submitted to you that the underlying concern is not so much which of the plans but to come forward and have that plan. Is that right or not?

Mr. LEVY. If I left that impression I'm sorry that I have and I'd like to clarify it.

We do not support the Treasury plan. One of the basic concerns we have in the business is keeping all of the healthy members onboard ship and paying. What we're really doing, we've got to keep all of those healthy people around and keep them as ongoing payers to make up for the arrearage in the fund of the plan that's in place.

TWO SERIOUS CONCERNS WITH THE TREASURY PLAN

We have two serious concerns with the Treasury plan. One is that it's going to scare off those healthy people because we don't see how the special assessment can ever be phased out. The debt service on the $15 billion will run about 1½ times the regular assessment, so we don't see that we'll ever have an end to the special assessments.

We are more deeply concerned about the impact it's going to have in the areas, for example, in Texas, Louisiana, and Oklahoma. By putting the amount of money that that plan has available on the table, we think it's going to greatly accelerate the disposal of real estate in those areas at a time when the markets are near chaotic. We think that that process should not be moving at a faster pace.

We are concerned that this allows that to happen, to write down the aggressiveness and the fact that at the end of 1988 the tax-free reorganization aspects that are available under the current law sunset, and starting in 1989 the cost resolution in problem situations is going to be substantially higher and that's going to propel them to—as it would if you or I were making the decisions—to try and get as much done in as short a period of time as possible. Again, I think that exacerbates this problem in the economically depressed areas.

I don't think we want to get into a situation where we compel a too rapid sale of real estate into those areas.

The one bottom line thing that we have some great difficulty dealing with—we're putting as much money on the table in 2 years as they are. We give the Congress a chance to review it. In the budget that has been presented, in the fiscal budget for 1988, we look at the 2-year projection and in addition to the regular special assessments, the Bank Board calls for spending $3.8 billion in the first fiscal year, $700 million in the second. That's $4.5 billion and we're talking about giving them $5 billion. So we think we're putting enough money on the table to cover the next 2 years. There's so much uncertainty.

This problem is so big, the uncertainty is so great, we must revisit it. I think that even if we pass a long-term plan you are going to be compelled to come back and revisit it. This isn't something that we can just park and put aside and forget about.

Senator D'AMATO. Now when you expressed these concerns to Treasury, what was their response and were you a part of that team?

Mr. LEVY. I have been on a number of occasions. I wasn't there for the most recent. If I can paraphrase, I think the essential position is that they were asked by the Congress to come forth with a plan that deals with the problem and I think they feel that their charge is to come forward with a plan that now makes certain assumptions but deals totally with the problem.

I think our approach is, we go along with that for 2 years but we think that there are so many variables that we can't—we're going to have to continually look at this thing. It's too fluid and we would like to buy 2 years' time, put $9 billion in—we're not stepping away from our obligation. We're not talking about consumers or taxpayers footing this bill. We're talking about the savings and loans paying it. It's our money being put up on the table.

But before we go $15 billion in debt with a debt service that could be $1½ billion a year, we say, let's take it a couple steps at a time; let's get through the first 2 years and let's take another look and then let's go forward.

Senator D'AMATO. Well, Mr. Chairman, my time has expired, but I think this is a crucial area and one that we should spend some time looking at very carefully as to which of these plans would best serve us.

The CHAIRMAN. I agree. I think the question was excellent and I think the responses were very constructive too.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Levy, in your testimony you talk about the linkage, as I would call it, between closing the nonbank bank loophole and I guess the future viability of a lot of thrifts out there. Would you care to elaborate on that?

Mr. LEVY. I think the linkage that we see between the nonbank bank loophole is that, in dealing with problem cases, there has been some value in entry rights——

Senator SHELBY. When you're talking about problem cases, you're talking about many, many institutions, aren't you?

Mr. LEVY. Well, we're talking probably 300 to 400 institutions. There's no entry value if anybody can go anywhere they want at minimal cost. If you don't set some kind of price for coming in it will affect the long-term cost of the FSLIC.

Senator SHELBY. OK. Following up on what Senator Garn asked you, we're going to talk about and we're going to debate it and we have debated what to do. How are we going to do it? I know you talk about it being retroactive. Retroactive to when? That's a question in itself, if that's an approach that we do, if we do anything.

Mr. LEVY. Well, clearly, the retroactive part is a difficult thing to deal with. If you bring it forward to the point where everybody is inside the door, it probably doesn't matter.

EQUITY PROBLEM IN RETROACTIVITY

Senator SHELBY. Isn't there an equity problem in dealing with retroactivity?

Mr. LEVY. Yes, who's in the door and who's out? Let me underscore it in the question that Senator Garn raised. If there's some sense that we see the closing of the nonbank bank loophole as the ultimate solution to the problems of the FSLIC, that isn't true. We see it as one item that could reduce the overall cost in resolving the FSLIC problem specifically in that sense.

Senator SHELBY. You used the word in your testimony "disincentive" for thrifts to acquire the failing thrifts. I guess that's what you're talking about through the openness of the nonbank bank loophole.

Do you believe that for these several hundred thrifts that you just mentioned to survive there's got to be a tremendous incentive out there in that acquisition mode?

Mr. LEVY. Well, I think that in the group that we've talked about—and I don't have the numbers, but clearly, the $9 billion that we propose putting on the table—a number of those institutions are going to be dealt with in one form or another in terms of case resolution and the attractiveness of coming in will be related to the availability of the dollars we're talking about.

But there's still a core group of 150 or 200 I'm sure out there. The value in being able to create mergers is allowing people to cross lines and go into markets that they don't service today.

Senator SHELBY. Let's talk about the word "bank." Do you have some suggestions as to a redefinition of that word?

Mr. LEVY. Well, I think if we describe a bank as any institution that either took deposits or made loans, rather than did both, I think you pretty well encompass the activities.

Senator SHELBY. That's pretty narrow, isn't it?

Mr. LEVY. Yes, it's narrow but it really gets at the division that we have now and the ability to move out into the markets on the basis of doing one or the other function.

Senator SHELBY. What about certain people arguing and in some areas rather successfully that you've got to compete in the marketplace whether you're a thrift, whether you're a regular bank or a financial institution, and because of technology and the market forces working out there times have changed. They have changed tremendously and it's going to be harder and harder to take things back.

Mr. LEVY. Well, it's clear. I think we've been living in that cold dark world for 4 or 5 years and the problems we're dealing with relate to the realities of that kind of world. It's a competitive world and we understand that.

Senator SHELBY. Are you familiar with some marketing surveys showing that—I've seen some of them in some of the literature that's been given out here—that some of the marketing polls have shown that an overwhelming majority of the people seem to be satisfied with the explosion in all kinds of financial institutions across the country.

Mr. LEVY. I haven't seen the study you refer to.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Let me ask you, continuing on the FSLIC plan, would the U.S. League be more supportive of the Treasury plan if the bonds issued by the financing corporation were made callable? Would that make any difference to either of you?

Mr. **Levy**. Well, on the question of callable bonds and we have addressed that, I suppose the tradeoff there is, yes, callable bonds sound attractive but they have to be weighed against the additional costs in terms of issuance and I think, one, what price do we pay for a callable bond and then I think you have to address the second part of that question, if they are callable, so what? I mean, where are the funds to call them prematurely? I don't know that we've been able to come up with an answer for that.

But the initial reaction is, yes, we are intrigued by the idea of callable bonds, but we are still——

Senator **Heinz**. But you would like to know what the premium is?

Mr. **Levy**. What the premium is and what the ability is to exercise it. Is it worth paying a premium? It certainly isn't worth paying the premium if you can't project the fact that you might at some time be able to exercise the call. If you can decide that you can exercise it at some point, then you value the costs.

Senator **Heinz**. Have you given any thought to what kind of a mechanism or framework could be used to exercise them appropriately?

Mr. **Levy**. No, we have not.

Senator **Heinz**. Mr. Gaiswinkler, have you any comment?

Mr. **Gaiswinkler**. We have not had a chance to study their proposal. It just came out yesterday, so we have no comment on it at this time.

Senator **Heinz**. Now another problem that I understand you have with the Treasury proposal is that there is almost no limit—there's too much money—and it has been proposed that there be an annual cap on the bonding authority.

Would you feel better, would you support the Treasury proposal if there was an annual cap on the bonding authority of the corporation which did not exceed $5.5 billion?

Mr. **Levy**. Well, I think once you get down to the question of the annual cap I think you're acknowledging some of the issues that we have raised and the concerns that we have about the ability to deal with the amount of dollars that could be available under a broader plan. It also addresses the problem of how quickly you deal with real estate in troubled areas.

But I would guess, having been an attorney, you always answer a question with a question. We come back and say, then why not our proposal which in effect not only does that but goes one step further and keeps Congress in play as a real oversight mechanism to assure that if conditions change, if the variables are there, why shouldn't you have the opportunity to review that and go forward?

WANT CONGRESSIONAL OVERSIGHT

For example, you could have the Treasury proposal one-third of what they propose across the board and say 2 years it's readdressed. We absolutely want the oversight. We want this thing to be reviewed, but we do want to keep our members onboard as payers. And I think you build a much higher comfort level with our members from the statements I've heard from our own members.

Senator HEINZ. I understand that, but I'm trying to understand your thoughts about the dynamics of a cap. I know it may not be—from your membership's point of view—preferable to what you have asked for in your plan, but it's helpful to us if you can discuss the pros and cons of a cap. You're saying on the one hand, yes, it's better than what's there, but I wasn't clear on what your specific reservations were about it, what the tradeoffs would be, not so much versus your own proposal but what the difficulties with a cap would be.

Mr. LEVY. I think the cap only addresses part of the problem because from the standpoint of the member who is ultimately going to pay they have to look at it and say you have approved a $15 billion program and they have to look at what all of that means and even within the framework of annual caps on the raising of the funds all of the other things that I talked about are still there. The fact is, there will be no phasedown. We are now paying two and a half times what a commercial bank pays for deposit insurance and that will remain because the regular assessment cannot cover the debt service. So all of those things are still in place so we still come back and say we would prefer the alternative.

Senator HEINZ. What about the special assessment, is that a big concern, the fact that there's no end in sight?

Mr. LEVY. Absolutely, and particularly to the publicly held companies in terms of reporting and costs, sure.

Senator HEINZ. I think my time is about up, but would it help if there was some provision to phase out the special assessment?

Mr. LEVY. The answer is yes, but in reality, the Treasury plan—you can put in a proposal to phase it out but then ultimately we're going to be sitting around and saying how do we service the debt because the regular assessment will raise less money than will have to be paid on the debt service annually. So we just don't see with that plan how you ever do it.

Senator HEINZ. Thank you.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Gentlemen, the day before yesterday there was a report in the Wall Street Journal that if the U.S. League didn't get what it wanted by way of short-term recapitalization of the Federal Savings and Loan Insurance Corporation, that it would likely support a merger of FSLIC into the FDIC.

Are those reports accurate, that you would support a merger of FSLIC and FDIC in the event the short-term recapitalization was not available?

Mr. LEVY. Senator, the board of directors of the U.S. League of Savings Institutions met last Friday and after hearing the various plans, one of the final votes taken was a set of priorities. Priority 1 was to support our plan and to see that $9 billion was made available to the FSLIC over the next 2 years.

The question then is, in lieu of that, do we support the Treasury plan? And the response was "No."

The second step was, not that we ask for a combination of the funds but as a next step we start an internal exploration of bringing the two funds together. Now that is not outside the framework of putting the $9 billion on the table. That assumes the $9 billion goes on the table.

We understand the complexities of raising that issue. It's not something to be resolved in 6 weeks or 2 or 3 months. It's a matter that would be discussed over a period of time and we think that it is not inconceivable. There are some segments of our group that feel there's an inevitability to that discussion and the 2-year timeframe that we talked about allows the opportunity to have a forum to see that issue raised and discussed. I hope I've answered your question.

Senator SASSER. Gentlemen, I hear repeated reports coming out of Texas primarily and some of the troubles S&L's in that area that the regulators are actually making matters worse, that their activities are really counterproductive in many cases, that they are in fact driving certain S&L's under in a situation where if a better business sense were used that the S&L's could survive or the loss to FSLIC would be significantly minimized.

What is your reaction to these reports? Are they accurate? If they are accurate, could you elaborate on them to some extent?

Mr. GAISWINKLER. Senator, I know of no particular incidents that you're referring to. I've heard rumors and that's all it's been as far as I know.

We take the attitude at the National Council that when these funds are put into the FSLIC there should be a defined two-tier approach. In other words, when those funds are expended, if it is in an economically depressed area, one that where perhaps real estate values will come back up and will make the institution solvent, they are the ones that should be given some kind of forbearance so that they just don't take these funds and immediately walk in and close the door on a particular institution.

Mr. LEVY. Before going to sleep last night I had C-Span on for a moment and I think the last thing I heard before I flipped it off was Chairman Volcker saying, "A bank can't operate marking its assets to market every quarter."

Senator SASSER. Could you repeat that, Mr. Levy?

Mr. LEVY. The comment that I understood was that a bank can't operate efficiently marking its assets to market every quarter. What we have going on in Texas is a marketing of the assets of the institutions to market at the bottom of the market.

R41C APPRAISAL STANDARD

The real problem—I'm sorry that Mr. McAllister isn't here from San Antonio Savings; he was present yesterday at the hearing before the House Banking Committee—we have something called R41C. It's an appraisal standard regulation set forth by the Bank Board. It follows regulatory accounting and regulatory appraisal evaluation rather than following GAAP appraisal evaluation. That's the reference I made earlier.

Mr. McAllister reports numerous cases of appraisals being made with the discounting of 12 to 14 percent on value. Now if you follow GAAP standards net realizable values, you would be working with the cost of funds to the institution which would be 6 to 7 percent. So you have a very deep discounting of real estate and that requires an immediate writedown against the capital of the institution and in effect forces more institutions into this 300 or 400 category. Nobody knows how big the problem is going to be, certainly, if you use an aggressive mode of writing down assets in this area. That's how we get the $6 million a day loss. It's through the writedown of assets and you're absolutely right.

And what we're asking for and we presented to the Bank Board is a policy of forbearance that would parallel the forbearance proposals that have been put forward by the Comptroller of the Currency and by the FDIC. And they allow for more leniency. They allow for the use of different kinds of appraisal evaluations. You're absolutely correct because this reevaluation of real estate is creating very, very difficult situations in those areas.

Senator SASSER. And this real estate—my time is up. Just let me ask this one question, Mr. Chairman. We're evaluating this real estate now at the bottom of the market and putting on top of that a 12-percent devaluation?

Mr. LEVY. Well, they're doing an appraisal and they're using a 12 to 14 percent discounting. Mr. McAllister pointed out that last year there were 24,000 foreclosures in the city of Houston and his understanding is January will reflect the rate moving up to 3,000 for the month. We're dealing with experience levels in some of these areas that absolutely are at depression levels and I think there has to be a recognition. We don't want to close these people but we look at the savings bank experience. These people have absolutely come back to health because there was forbearance and there was tolerance during the early 1980's and we ask for the same.

Senator SASSER. My point is this, that the Bank Board is acting inadvertently, through inadvertent action, is further depleting the insurance funds. Is that correct?

Mr. LEVY. Well, I would say this, if there's a fault to be put, I would not put it on the Bank Board. I would put it on us. I had a task force I chaired for the U.S. League 1 year ago and we came out of that task force roaring and saying, "Enough, stop this thing; it's our bill to pay; we want you to go out and take care of these problem cases." And we supported a very aggressive approach by the Bank Board. We asked that it be targeted. But I don't think any of us knew as this process started that the marketplace would spiral—the real estate markets, the whole economy in the region we're talking about would go down as quickly or as deeply as it has.

And we're saying we all have to step back. It's not a matter of assessing blame or guilt or wrong, but I think it's time to step back and consider forbearance and recognize the uniqueness of the situation there and allow those people a chance to work their way through this—the well-managed people. I'm not talking about the people that were out there doing crazy things. I'm talking about well-managed institutions down there that are being caught in this trap.

The CHAIRMAN. Thank you, Senator Sasser.

Senator Heinz.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. In reviewing the debate over financial service reform to date, I think it is fair to say that the industry is beset with a myriad number of problems which, if not solved, could have a severe impact on the continued viability of our financial marketplace. With the deregulation tidal wave that has been with us over the past 6 years, we are seeing that competition among markets and players is greater than ever. While some take the position that the marketplace should be regulated solely by competition and that complete deregulation is the ultimate solution, I am not prepared to subscribe to that view at this time. It may well be that an additional dosage of deregulation is the answer but we will not know that until we have the kind of far reaching exploration of the issues.

I am prepared to make this commitment. However, there are, in my opinion, two other issues which must be resolved before this committee and Congress can rationally, responsibly, and effectively review and reevaluate the legal structure of the American financial system, including the barrier established by Glass-Steagall.

The first is recapitalizing the FSLIC fund. The FSLIC is facing not only the long-term viability crisis but also an immediate liquidity crisis. There is absolute consensus that it is the high-priority item before the committee. We can and should act on it without failing to provide the insurance fund with sufficient financial and organizational resources as well as the flexibility to deal with its caseload, ensure the viability of the fund and bolster depositor confidence in the system. Although an alternative proposal has been offered by the U.S. League—which will be more fully disclosed today--I am concerned that the need to stabilize the FSLIC and the thrift industry immediately must take precedence over this new and untested alternative.

Second, and equally as important, until the disparity in regulatory treatment between companies owning banks and those owning nonbank business is eliminated, we cannot approach—with cool heads—the vital review of our banking laws. Closing the so-called nonbank bank loophole—under which a firm that only takes deposits or only makes loans can escape regulation under the bank holding company—is a crucial complement to any legislative review. Right now, nonbanking firms can own these limited service banks and can operate outside the parameters of Federal law regulating geographic and product expansion of bank holding companies. The nonbank banks are accorded the same protections of the Federal safety net as their counterparts, that is, deposit insurance, access to the discount window and the guarantee of payments made over fedwire. Yet, the owners of these institutions are not subject to the same rules as other companies which own banks. I believe they should be; otherwise, the potential for abuse of the system moves to the realm of reality.

Mr. Chairman, we must tie the FSLIC recapitalization efforts to eliminating the inequity created by the nonbank bank. Neither effort can stand on its own; nor can further comprehensive review of the banking system in the absence of either proposal. I commend you for moving in this direction.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. Senator Sasser and others have asked several questions that I would have asked. I would like to ask one.

Let me say that I respect the U.S. League's desire to see to it that we don't recapitalize with more funds than are really needed at any stage.

WISE USE OF PROPOSED FUNDS

Assuming that there will be some infusion of funds, could you outline just very succinctly and point by point the steps you think should be taken to assure that those funds will be wisely used?

Mr. LEVY. Well, if the funds were available, I think a lot of steps have been taken over the past year to assure that they will be wisely used. I think we identified a problem 1 year ago of substantial staff shortages at the FSLIC. They were operating under budget restrictions. They weren't able to staff up to the extent that the FDIC was able to do and wisely the Chairman established the Federal Asset Disposition Association which gave them a company which has now grown with a staff of 160 or 170 highly trained, very specialized real estate work-out people to assure that as these funds are used and as the real estate is exposed to the marketplace that it's going to be done in a proper and businesslike fashion.

So we think there's still more to be done, but we think we've come a long way from 1 year ago in terms of the use of the funds.

Mr. GAISWINKLER. Senator, if I may add something to that, the Council is on record in support of the Bank Board and the Treasury recapitalization bill. One of the caveats we have—not as a condition of our support—but one of the things that we would talk to them about when the plan is finalized is the fact that the Industry Advisory Committee, which is appointed in that Treasury proposal does not seem to have any teeth in it. Since it is our money we would like to have more to say about how it is done and we certainly would like to have the Congress have some sort of oversight rights to also observe what is done and how it is done. They should submit budgets and so forth which I believe, with the proper oversight of the Advisory Committee, could improve this operation.

Mr. LEVY. Senator, may I just footnote and say that the oversight that would be provided in the 2-year bill in terms of all of this is important because the one thing we do know is the Board is going to go through a transition sometime in the next 2 years. So we really like the idea that there is a mandated oversight in terms of having a 2-year proposal.

Senator CRANSTON. Thank you very much. I don't have any further questions.

The CHAIRMAN. Well, thank you, gentlemen. I just would like to ask Mr. Levy, in response to Senator Garn's challenge to put in writing what you think what we ought to do about the nonbank bank loophole, how we ought to handle that, I suggest that you might consider the possibility of limiting the powers of the nonbank bank. I suggest to prohibit them from cross-marketing, for example, products or services not otherwise available to bank holding companies, no new locations, no daylight overdrafts, as well as a grandfather date as far back as possible. But I'm sure you will have far better answers than I could suggest to you, but you might keep that in mind.

Mr. Stolberg and Mr. Kuthy are our next two witnesses. That's our first panel but we changed that. Mr. Stolberg, you were at Dulles I believe and so we postponed your panel.

Mr. Stolberg is the speaker of the Connecticut House of Representatives and the president of the National Conference of State Legislatures. We're delighted and honored to have you. Go right ahead, sir. You have 5 minutes. Keep an eye on the green light here that will go on in 1 minute and it will turn red when your 5 minutes are up. So go right ahead, sir.

STATEMENT OF IRVING J. STOLBERG, SPEAKER, CONNECTICUT HOUSE OF REPRESENTIVES; AND PRESIDENT, NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. STOLBERG. Thank you very much. Senator, you have my prepared remarks. I am going to augment those a bit.

It's a pleasure to be with you today. I am speaking both as Speaker of the House of Connecticut and as president of the National Conference of State Legislatures.

There are a number of issues you have before you and I would at the outset urge that the recognition of the dual banking system and that the responsibilities of both the Federal and State Governments be recognized in the shaping of your legislation.

There are a number of issues I'll just touch on very briefly and will of course be available to your questions, Senator.

CREDIT CARD INTEREST RATES

First, I think it is appropriate for you to look at credit card interest rates. In my opinion, the sharp drop in the cost of money to the banks has not been accompanied by their lowering credit card interest rates in particular and consumer credit in general.

Let me just share for a moment our experience in Connecticut. A number of years ago we had a 15-percent cap on credit card interest. The banks came to us requesting, because of the high cost of money, a higher rate. We took it to 18 percent with the understanding that when conditions allowed it would go back down. Well, sir, conditions allow.

The banks forgot that agreement and vigorously opposed our effort to take the cap back down to 15 percent. An amendment was put in. I had the pleasure of having an overwhelming vote in the house and then in the senate and we did take our cap back down to 15 percent.

I would suggest it could even be lower and still have a very reasonable profit being made by the major banks in the country.

On check holds, Senator, I think the time has come to act on that. I think for Government checks, for local transactions, anywhere from zero to 2 days is adequate and certainly no more than 1 week on any transactions of normal customers. Certainly high-risk customers can be treated differently but we all shouldn't have to pay the price for them.

I think truth-in-lending where the consumers can actually know what they are paying, what their interest rates are when the credit charges kick in, is called for. That is certainly not being done now and is a disservice to the consumer.

In terms of nonbank bank legislation, I would salute you, Senator. I think the time has come to close the loophole on that. I do not think that should be an entry point for a number of institutions to try to evade State legislation, and I salute you in your efforts to accomplish closing the loophole. We certainly support that.

The recapitalization of FSLIC is something that is called for. I think it's necessary. I've heard figures of $15, $19, and $30 billion. I hope you will measure the amount necessary and provide an internally funded mechanism for the recapitalization that is called for.

In your addressing failed or failing banks, I do hope you will recognize the State role in the system. I think the in-State preference should be maintained but I do think that Federal action is called for.

I know that Senator Dodd is not here at the moment but he and I have discussed the South Dakota loophole and I hope that can also, either in the original legislation or in follow up legislation, be addressed.

Again, I appreciate your juggling the panel. I did have an interesting trip starting at 5 o'clock this morning in New Haven, and did get to see a lot of the beautiful snow covered countryside of Virginia on the way in. Thank you.

[The complete prepared statement follows:]

service charges, and account balances. Community reinvestment by financial institutions should be encouraged by federal law.

I should add at this point a cautionary note. While NCSL will support federal legislation on non-bank banks, check holds, FSLIC recapitalization, and so forth, such legislation to the maximum extent feasible should respect the system of dual state and federal regulation of financial institutions. We would, for example, want to closely examine legislation recapitalizing FSLIC to ensure that it does not unnecessarily diminish state authority over state-chartered thrift institutions.

For another example, while NCSL supports the grant of emergency interstate acquisition authority to the federal government, we believe that grant of authority, in order to safeguard state autonomy, ought not to sweep too broadly. Due in large part to economic downturns in the agricultural and energy sectors and to speculation and mismanagement by some institutions, bank failures have increased at an alarming rate. One hundred and twenty banks failed in 1985. But, state legislatures have responded by passing emergency interstate acquisition legislation and by easing intrastate branching restrictions. This legislation takes into account state economic conditions and the impact of takeovers on individual communities. NCSL's members believe that federal law should not supercede carefully-crafted state statutes.

NCSL recommends the retention of the $500 million asset threshold in any new federal emergency acquisitions legislation. A lower threshold could apply in those instances where a state had no banks with assets of $500 million or more. In such circumstances, the law could allow up to five of the states' largest institutions, if in troubled condition, to qualify for emergency acquisition under federal law. Furthermore, any new legislation should retain an explicit preference for in-state buyers. If in-state buyers are not forthcoming, the next preference should be given to out-of-state banks in accord with state law. Finally, if a new bill covers "failing" as well as failed institutions, NCSL recommends that "failing" be defined in narrow terms to guard against overreaching by federal authorities.

Similarly, while NCSL supports federal legislation that would allow commercial bank underwriting of municipal revenue bonds, we urge you to consider the capacity of regulators to ensure the safety and soundness of institutions when you grant other new powers to bank holding companies. Be sure that the appropriate regulatory tools are in place before you grant new powers in areas such as securities brokerage, real estate, insurance and other financial services.

Mr. Chairman, I want to thank you for this opportunity to testify on behalf of the states who have been on the forefront of banking legislation. I am confident that you will be able to resolve through legislation many of our pressing problems related to federal bank regulation. I am also confident that you are as committed as we are to the dual banking system and that you will take care not to unnecessarily preempt state law. Again, we urge you to act expeditiously.

The CHAIRMAN. What a marvelous attitude. I wish we all had that kind of attitude about this miserable weather.

Mr. Kuthy, go right ahead.

STATEMENT OF EUGENE W. KUTHY, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. KUTHY. Mr. Chairman and members of the committee, I am Eugene W. Kuthy, commissioner of financial institutions for the State of Michigan and president-elect of the Conference of State Bank Supervisors on whose behalf I am testifying today.

I would like to preface my comments by commending to you some conceptual material that helps to underscore my later comments. Regulation is undertaken we know in this country when public need and interest is shown and typically we go through the steps of assessing the cost of that regulation versus the public benefit with the objective to obtain and maximize public benefit and minimize costs.

We have approached banking in that fashion over the past two centuries. Public interest legislation based on two overriding very public concerns—control of the harms that result from the mixing of banking and commerce has been a regular theme and the prevention of the undue concentration of financial economic power has certainly been another.

These concerns were explicitly written into the Bank Holding Company Act section 4(c)8 and that is available to us all.

It requires the Federal Reserve to identify protected benefits or harms, strike balances, design a system responsive to their determination of what those balances ought to be. but probably most importantly, certainly from the standpoint of Mr. Stolberg and myself, it retains the State authority over the activities of State-chartered banks.

Shifting a bit now from that presentation, I would commend to you that because of this we clearly support new bank powers in the underwriting of municipal revenue bonds, mortgage-backed securities, commercial paper, and to the extent we get further specifics, mutual funds perhaps.

OPPOSE PREEMPTION OF STATE AUTHORITY

We strongly oppose the broad preemption of State authority over the power of State-chartered nonmember banks.

Consistently, we have opposed the proposition that State-chartered subsidiaries of holding companies be limited to the insurance activities permitted to their corporate nonbanking subsidiaries or holding companies. Many of these arguments go right to the heart of the dual banking system and the way it's been established and run for some 200 years, as especially noted in the Bank Holding Company Act.

We must maintain, we feel, States as laboratories for change, for transitional change, for incremental change, for that kind of change that doesn't lead to utter disruption of the national banking system.

State powers, we believe, will lead to improved local service. State authority over State-chartered banks lends to that kind of healthy flexibility and dynamic tension that has made for a better overall national system.

Accordingly, we would submit to you that preemption of State authority is not in the public interest. It's too large a net given the present conditions and circumstances of our financial services, as Senator Garn so aptly and properly noted earlier.

Moreover, we would submit that perhaps it may not even be necessary since August 1985 when the Federal Reserve turned down the application of Citicorp to use a State's banking law to establish an insurance subsidiary in the name of a State bank, which was a clear attempt to evade the purposes of the Bank Holding Company Act.

In consistant litany with earlier testimony, we support closing the nonbank bank loophole, which is a mechanism to achieve exactly the results that the Bank Holding Company Act was designed to prevent.

If there were no problems with undue concentration of financial and economic power or the mixing of commerce and banking, we wouldn't have had the Bank Holding Company Act. Thus, we need to close the loophole, to prevent disruption to our system of bank structure and regulation. If Congress is unwilling to do so or even is willing to grandfather companies who own nonbank banks, should these companies then be placed under the Federal Reserve's jurisdiction for the purpose of preventing unfair methods of competition, unsafe or unsound practices, and practices that present conflicts of interest.

I now terminate my comments because the red light told me to do so.

[The complete prepared statement follows:]

STATEMENT BY

IRVING J. STOLBERG
SPEAKER, CONNECTICUT HOUSE OF REPRESENTATIVES
PRESIDENT, NATIONAL CONFERENCE
OF STATE LEGISLATURES

I am Irving J. Stolberg, Speaker of the Connecticut House of Representatives and President of the National Conference of State Legislatures. I appear today on behalf of NCSL to share with you our policy positions on banking legislation. I appear also representing state lawmakers with a keen interest in banking issues. I sponsored consumer banking legislation that placed a cap on credit card interest rates in Connecticut. I would like to share with you our experience in Connecticut and the other states in the hope it might be useful in crafting federal legislation.

As President of NCSL, I preside over an organization representing all the nation's 7,461 state lawmakers. NCSL's policy resolutions are adopted by an affirmative vote of at least three-quarters of the states attending our State-Federal Assembly. Our policies are therefore general agreements among state legislators that transend party, region, and philosophy. We have adopted policies on several issues of concern to this committee.

I would like to communicate NCSL's formal recommendations for federal banking legislation. NCSL supports federal legislation to curb excessive check-holds and to close the non-bank bank loophole. At the same time, we oppose any provisions in federal legislation that would threaten the dual banking system or unnecessarily preempt state banking law and regulation.

Our federal system presents opportunities and obligations for both our state and federal governments with respect to banking regulation. The dual system has served us well and can respond to the challenge of a rapidly-changing financial service marketplace. State legislatures have been active in banking policy, and I urge Congress to be active in its sphere. State and federal policy need not conflict. An aggressive federal response to the needs of consumers and communities would reinforce, not undermine state legislatures. We urge you to act expeditiously.

The times truly demand legislative action. As a result of deregulation and the rapid rate of marketplace change and innovation, the U.S. banking system has been transformed over the past decade. States have been moving steadily toward regional banking arrangements. Non-bank banks have proliferated, avoiding interstate banking laws. Financial institutions have aggressively sought out new markets and new services to offer the consumer. Seemingly invulnerable institutions have failed or faced serious financial difficulty while other more-enterprising institutions have expanded rapidly, perhaps even recklessly. Bank and saving and loan failures have increased dramatically. The number of financially troubled institutions is perilously high, especially in agriculture and energy states. And, risky international loans threaten the stability of the whole system.

Unfortunately, there are increased risks for consumers as a result of these changes in the banking economy. We hope that increased competition will result in better financial services at a lower price. But, we clearly see disturbing signs that the benefits are not trickling down to individual consumers. Many consumers are confused by rapidly changing and complex fees. Moreover, they are not given adequate notice of interest rate and fee charges. Credit card interest rates are obscene, resulting in excess profits for banks and considerable financial pain for American families. Banks have also been imposing check holds for excessively long periods and earning interest on the float. Many consumers, especially the old and the poor, have been faced with new fees and restrictions on basic banking services. Many urban and agricultural communities face the specter of divestment as financial institutions increasingly lose their local orientation and long-term commitment to growth of communities. Small businesses may be particularly hard hit by the increased concentration of the banking industry.

State legislatures are responding to the challenge and seeking to protect consumers and communities. In Connecticut, we placed a cap on credit card interest rates. Twenty-nine other states have similar caps. Thirteen states have adopted check hold legislation or regulations. An NCSL survey indicates that banking issues will again be near the top of the state legislative agenda in 1987. Twelve states expect proposals to limit service charges to low-income consumers. Eight states expect bills to limit service charges for all consumers. Fifteen states expect check hold proposals. Twenty-six states indicate bills related to credit card interest rates will be considered by their legislatures in 1987.

But, state legislation alone is not enough. Congress must also act. NCSL has adopted policy urging federal legislation on a number of fronts.

NCSL supports federal legislation to reduce the excessive delays in fund withdrawal imposed on many consumers as a result of bank check hold policies. Holds of two-to-three weeks duration appear to be arbitrarily applied to known customers depositing federal tax refunds and similar government checks and to many others who present minimal risk. While there are justifiable reasons to restrict access to some depositors such as those opening new accounts or known bad-check writers, there is no good rationale for including legitimate customers under an "umbrella of suspicion" for excessive periods.

NCSL supports federal legislation to close the "non-bank bank" loophole. Non-bank banks, of course, have state or federal bank charters but because they do not accept demand deposits and make commercial loans, they are technically not banks under the bank holding company act. In this way, interstate banking limitations are avoided. The question of whether non-bank banks should be allowed within their borders is appropriately for states to determine, but the avoidance of interstate banking laws must be stopped. Adequate state regulatory authority to protect consumers and assure the soundness of the banking system depends on closing the loophole.

NCSL supports proposals to recapitalize the Federal Savings and Loan Insurance Corporation with internal, system-generated resources. We also believe that Congress and the Administration should take action to ensure that FSLIC promptly identifies troubled thrift institutions and intervenes to protect depositors and communities. This may require increased funding and staffing for the FSLIC. Congress should also modify FSLIC premium assessments to ensure that they relate to an institutions' performance and the safety of its investments. Steps must also be taken to assure through appropriate disclosure that savings institutions have adequate loan loss reserves and sufficient high-quality assets.

NCSL supports several other forms of federal banking legislation. We believe commercial bank powers should be expanded to allow the underwriting of municipal revenue bonds. Increased competition in this area could reduce costs for state and local governments. We are also particularly supportive of federal consumer protection and community reinvestment legislation. Bank customers should be guaranteed access to basic services. Financial institutions should be required to disclose information about interest rates,

STATEMENT OF EUGENE W. KUTHY
ON BEHALF OF
THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. Chairman, members of the Subcommittee, I am Eugene W. Kuthy, Commissioner of Financial Institutions for the State of Michigan and President-Elect of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearinghouse for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify before this Committee and address several issues regarding current banking regulation and deregulation.

BASIC CONCEPTS

It is commonly agreed that before the regulation of a sector of the economy is undertaken, a public interest need for such regulation must be identified. If such a need is found, the cost of regulation, generally, must be weighed against the public benefit which may be expected to accrue from such regulation. Then a specific system of regulation should be selected to

maximize the public benefit while minimizing the cost. Presumably, under our system of government, government interference with the private sector is undertaken only when necessary and cost-beneficial. In this manner, we seek to maximize productivity on the private side and maximize benefit per dollar spent on the public side.

Banking is a regulated industry. The members of Congress who walked these halls during the past two centuries decided that there was a need for bank regulation and that the system they were fashioning would operate in a manner which would generate a net public benefit. Obviously, there were some specific factual situations at the time of the passage of restrictive legislation which have changed and which we now have the luxury of viewing in historical perspective. But there were also several overriding public concerns, more general in nature, which transcend the specific facts of any given point in time.

These broader public concerns constitute an appropriate framework within which a system of regulation may be analyzed. And that is what is required in any meaningful discussion of the continuing validity of that system of regulation.

THE BANK HOLDING COMPANY ACT

The Bank Holding Company Act (the "Act") represents an effort to control the public harms which may result from the mixing of banking and commerce and to prevent undue concentrations of economic power. As such, it is a continuation of themes which are found throughout the history of bank regulation. The Act provides for measured deregulation of the banking industry in areas beyond traditional banking services. It was Congressional response both to the need for some service expansion and to the feeling that there was danger in moving too quickly or too far in the areas of permissible bank holding company activities and corporate ownership of financial institutions.

The section of the Act pertaining to non-banking activities of BHCs, Section 4, both provided the motivation for the passage of the Act and represented the trade-off between the two above-identified public interests. It delineates the standard for permissible non-banking activities and, thereby, limits the ownership of banks by corporations engaging in non-banking activities. The overriding public interest concerns were written right into the Act. The Act directs that the Federal Reserve Board shall consider certain factors in determining whether an activity is appropriate under 4(c)(8):

> In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an Affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

The Act requires the Federal Reserve Board to identify potential public benefits or harms, to strike a balance and to design a

system responsive to those policy determinations.

State authority over the activities of state-chartered banks, however, was maintained. As to these individual institutions, it is the primary regulator which makes these determinations. By focussing the chartering authority at the bank for which it is responsible and focussing Fed authority at the BHC and inter-subsidiary transactions, Congress has provided checks and balances which maintain the opportunity for reasoned evolution of our banking system.

Similarly, adopting the Douglas Amendment to the Bank Holding Company Act, Congress decided that the public interest is best served by retaining state authority to determine the banking structure best suited to local needs. The Douglas Amendment prohibits bank holding companies from expanding across state lines by the acquisition of a bank subsidiary, unless expressly authorized by state statute. This decentralized system was designed "to keep the private control of credit diffused as much as possible", yet allow for change. The authority to relax the prohibition on interstate bank ownership and control has been entrusted to the states. The states are to determine if changes in economic circumstances have altered the balance of public interest so as to warrant relaxation of the prohibition, and to what degree. June 10, 1985, the Supreme Court, in Northeast Bancorp v. Board of Governors of the Federal Reserve System, upheld the legality of state laws enacted pursuant to the Douglas Amendment. In doing so, the court recognized that banking is of "profound local concern" and "our country traditionally has favored widely dispersed control of banking."

PUBLIC INTERESTS IN REGULATION

Safety and soundness concerns are at the very heart of modern bank regulation. Such regulation is designed to maintain public confidence and to govern risk taking in banking. Deposit insurance complements safety and soundness regulation by helping to maintain public confidence and by insulating small depositors against risk. The public need for stability in our financial system dictated safety and soundness regulation, which has proven to be cost-beneficial. The inclusion of *"unsound banking practices"* among the "laundry list" factors is explicit recognition of the risks which attend the unregulated mixing of banking and commerce.

Public concern over the *undue concentration of financial resources* is reflected in both the limitations on the non-banking activities of the BHCs and the structural limitations contained in the Douglas Amendment. Aggregate concentration--the proportion of assets or output accounted for by the largest firms within the economy or some major sector thereof--has long been considered an important indicator of political and economic power. Aggregate concentration of financial resources in particular is to be shunned since the role of money as the medium of exchange for all commodities and the nexus for real investment capability carries with it inordinate power. Decentralized

control of structure provides the primary safeguard against undue concentration of private control over financial resources and regulatory authority over those resources.

It is not as fashionable as it once was to be concerned with the concentration of economic power. The promotion of competition and efficiency in service delivery has been the focus of recent attention, often at the expense of safety and soundness and concentration considerations.

The public benefit derived from the *promotion of competition* - the avoidance of decreased or unfair competition - is painfully clear. The difficulty is, and always has been, in striking an appropriate balance between short-term enhancement of competition, and avoiding longer-term anticompetitive tendencies in national credit markets. The decentralization of the American dual banking system is highlighted by decentralized control of structure and state-initiated experiments with new bank products and services.

The choice between national and state charters creates regulatory competition which produces a healthy, procompetitive creative tension for marketplace innovation while providing protection against the competition-stifling effects of overly burdensome regulation. Competition is *not* promoted over the long run by either the destruction of our decentralized dual banking system or the wholesale abandonment of the prudent restrictions on bank acquisitions and activities contained in the Bank Holding Company Act.

Conflicts of interest may arise when those who gather and redistribute capital are also allowed to take equity positions in other sectors of the economy. Both the separation of banking and commerce and our system of direct regulation, including transaction limitations and other consumer safeguards, such as anti-tie-in provisions and community reinvestment requirements, are designed to promote unbiased distribution of credit. It is clearly in the public interest to ensure that all sectors of the economy as well as all geographic areas are adequately and equitably served by financial intermediaries.

It is also clearly in the public interest to protect the franchise value of the bank charter. Congress must act to stem the tide of corporations which are not banks or bank holding companies, but which do own and operate banks or are otherwise offering bank-like services. In addition, you must consider the ability of banks to compete with other financial service providers and the effect that competitive imbalances may have on institutional safety and soundness. If you do not, the franchise value of banking will be so diminished that no businessman in his right mind would put up with the level of regulation imposed on banks in the public interest.

With these considerations in mind, CSBS has adopted a policy on the separation of banking and commerce which urges, among other things, that "banking ... be granted certain new powers or other types of institutions denied certain powers," consistent

with the principles of safety and soundness. That policy also holds that "To the extent new powers may be granted to banks to provide needed services or to permit banks to compete equitably, appropriate quantitative and/or qualitative limitations should be established to assure safety and soundness, unbiased allocation of financial resources and freedom from undue concentrations of financial or economic resources."

NEW BANK PRODUCTS AND SERVICES ARE NEEDED

CSBS recognizes that some expansion of bank and bank holding company roles is necessary to meet market challenges, to assure long-term viability of the industry, to give the public the benefits of increased competition, and to facilitate better allocation of financial resources. Among these powers, one which CSBS has long advocated, is bank underwriting of municipal revenue bonds, based primarily upon the benefits which would accrue to state and local governments and to the public at large, with little or no increase in risk to banks. Increased competition for underwriting municipal revenue bonds has great potential to reduce significantly the cost of revenue bond financing.

In 1933 Congress passed the Glass-Steagall Banking Act, which prohibited banks from either underwriting or trading most types of securities. Congress believed that bank involvement in the securities business had aggravated and hastened the collapse of the nation's financial system. While Glass-Steagall speci-

The **Chairman**. Thank you very much, Mr. Kuthy.

Mr. Stolberg, I can't resist getting into something that's a little beside the point because you started off with talking about predatory interest rates and credit cards as interest rates being too high.

You've done a good job in Connecticut. However, you can go too far, as Arkansas has found out. As you know, they've gone to 10 percent and they have practically no bank credit cards now in the State.

I think that some of us overlook the fact that there's a colossal amount of float, far more in credit cards than anything else—30 days you pay it back with no interest at all, no interest charge at all, none. It's interest-free. And I imagine that a very large proportion of people do. I understand that that justifies about a 3-percent increase for credit cards over other credit instruments.

Then the fraud losses for credit cards is very, very large. I understand that's another 3-percent minimum, maybe even higher, because so many credit cards are stolen and so forth.

But I think you're right that we certainly ought to take a look at it. I think Connecticut has done this in an effective way and in a moderate way. I think you're right that when the interest rates go down as they have, the fact that they've gone down to 15 percent—a lot of people think they ought to be 6 or 7 percent. Obviously, there's no way you can have a business operating on that basis in view of what credit cards cost.

Would you like to make any further comment?

Mr. **Stolberg**. Well, let me just comment that when we were considering the legislation the Connecticut banks—and of course this only applies to Connecticut banks, although we're hoping that perhaps with your assistance we can apply it to all the banks in the country that send credit cards into Connecticut, I think usury laws versus interstate commerce is an interesting challenge and we have legislation that may bring that to the fore this year.

CREDIT CARD RATES

In 1981, the discount rate was 13.4. The credit card rate was 17.8. Now the discount is down to 6.3. The credit cards, on average, is still 18.3. I think any credit card going to 18 or over today is an outrage to the consuming public.

The **Chairman**. Mr. Kuthy, you note on page 6 and 7 of your prepared testimony that the Bank Holding Company Act which Congress passed in 1956 and then strengthened in 1970 is designed in part to prevent the undue concentration of financial resources. You note that:

> The aggregate concentration of the proportion of assets or output accounted for by the largest firms within the economy or some section thereof has long been considered an important indication of political as well as economic power and is to be stopped since it carries with it inordinate power.

Do you think that not closing the nonbank bank loophole will bring about the concentration of economic and political power that Congress has acted to prevent in the past and what political dangers would we face, in your view, if we failed to act?

Mr. **Kuthy**. I think it's quite clear that systems that do not prevent concentration or at least ameliorate its worst result have a long history of establishing an inordinate political and financial and economic power which we have long shunned in this country. We have known of the results of such a system as early as the Founding Fathers, who were responding to that challenge from overseas.

Accordingly, without having that capability to either regulate or to forbid that kind of unmitigated concentration, I think we have the capability of moving in that direction quite easily.

The CHAIRMAN. Would you like to comment? Senator Garn made what I thought was a very eloquent and very persuasive argument that we can't just say no more nonbank banks. We can't just do it on the basis of grandfathering. We have to do more than that. And I suggested, as you may have heard, to Mr. Levy that we strike at the powers of nonbank banks and say they can't cross-market products or services not otherwise available to bank holding companies, no new locations for nonbank banks, and no daylight overdrafts. As you know, if you have a daylight overdraft you can Bert Lance your way to prosperity forever.

Mr. KUTHY. Those are quite clearly alternative techniques. Each of them strongly suggests an overall alternative which is regulation of nonbank banks if we're unable in the Congress to close the nonbank bank loophole and unable to determine the proper time for grandfathering.

The CHAIRMAN. In other words, put them under exactly the same regulations as a bank would be, forget about the definition of a bank and just say they're banks and should be regulated the same way. Is that right?

Mr. KUTHY. That is an alternative. Or the other alternative is to strike at those harms which section 4(c)8 was designed to strike at in the intermixture of banking and commerce and that is conflicts of interest and similar kinds of economic problems that arise from that potential intermixture.

The CHAIRMAN. Senator Garn.

RELATION OF THE FLOAT

Senator GARN. Mr. Stolberg, getting back to interest rate ceilings on credit cards, you essentially ignored what Chairman Proxmire is talking about concerning the float and the reasons why the interest rate is higher on that. You say it's an outrage and yet it doesn't make any difference to me whether they charge 50 percent. I love the fact that I can get 30 days of free credit. It doesn't cost me anything and I always pay mine off. I don't charge more than I can afford to pay. That option is available to anyone.

There are banks that are as low as 13 percent without passing laws. People can choose if they don't like what a particular bank charges. Why should we be getting involved in setting those kind of ceilings as a matter of principle, of us dictating in the free market and setting prices on anything? There are exorbitant prices in drug stores and department stores and so on on products. Aren't people smart enough to make decisions on their own?

Mr. STOLBERG. Senator, I laud your leadership in this area. Most of our States do have usury laws. I think we, as elected public officials, do have an obligation to our citizens and to our consumers. I fically applied the prohibition on underwriting to national and state member banks, the section prohibiting organizations involved in underwriting from accepting deposits has been interpreted as bringing state non-member banks within the statute.

A major exception to the general prohibition on underwriting issues of securities or stock permits the underwriting of "obligations of the United States, or general obligations of any state or any political subdivision thereof." The exception to permit banks to underwrite and trade in general obligations has been interpreted to prevent banks from underwriting and trading in municipal revenue bonds.

Municipal revenue bonds were rarely used as an instrument of municipal finance 48 years ago when the Glass-Steagall Act was enacted. General obligation bonds, payable from the general taxing authority, were the preferred instrument. However, revenue bond use has grown continually and now accounts for about 70% of the market. It is widely expected that they will continue to grow both proportionately and in absolute dollar amount.

It is estimated that bank participation in the underwriting and sale of municipal revenue bonds would save state and local governments up to $400 million annually. Increased competition will reduce the fees imposed by underwriters for bringing a new issue to market, will bring new customers into the municipal securities market, and will lower the interest rates issuers pay by increasing the liquidity of municipal revenue bonds.

Legislation permitting banks to compete in the municipal revenue bond market has passed the Senate twice since the mid-1960's, but has been blocked in Subcommittee in the House. Extensive hearings were held in the House in the fall of 1979, however, and support for this legislation has been growing.

CSBS generally supports legislation to permit banks to underwrite and sell municipal revenue bonds, provided that legislation does not preempt state authority and if appropriate safeguards are provided. One such proposal supported by CSBS would permit banks to underwrite and trade in investment grade municipal revenue bonds, already considered safe enough for banks to invest in. In addition, CSBS generally supports measures which would grant banks and BHCs authority to deal in commercial paper and municipal revenue bonds.

STATE AUTHORITY OVER PRODUCTS AND SERVICES OF STATE-CHARTERED BANKS

Moreover, CSBS strongly opposes broad preemption of state authority over the powers of state-chartered nonmember banks. Specifically, we oppose attempts to preempt the authority of states to authorize their state-chartered institutions which are subsidiaries of bank holding companies to engage in insurance activities beyond those authorized for the parent holding company. Under the current scheme of authorization and regulation embodied by the Bank Holding Company Act, states are free to permit state-chartered institutions to serve the public in ways consistent with the needs of each individual state, limited naturally by the controls on location with which banks must comply, which is also administered by the state. Interstate general corporate activities of holding companies, on the other hand, are controlled by the Congress and the Federal Reserve Board, both as to type of activity and location.

Current attempts to destroy this statutory scheme irrespective of the specific state bank service under question, constitutes an unwarranted preemption of state authority which is anti-competitive, anti-consumer and anti-state government. Such a change in current law would set a terrible precedent for federal interference with authority of states over their own institutions within their own borders.

The proposition that state-chartered banks affiliated with a holding company should be limited to the insurance activities permitted to corporate, non-banking subsidiaries of the holding company ignores the following very real public benefits provided by our dual banking system, which would be undermined.

. States operate as laboratories for change. Many states have long permitted activities which are not in all respects identical to those of either national banks or non-bank subsidiaries permitted under the Bank Holding Company Act. The ability of states to charter banking corporations carries with it the duty to determine an appropriate scope of activities. Such responsibility has resulted in important public benefits, has led banks to engage in controlled experimentation and has often

resulted in subsequent action by Congress authorizing similar functions; *e.g.*, bank branching in the 1920's and 1930's and NOW accounts in the 1970's. Indeed, one of the benefits of the dual banking system is that it motivates experimentation and innovation without putting the entire banking system at risk.

. State powers lead to improved local services. Needs of states differ. Because current Congressional activity was occasioned by a state's insurance statute, it is appropriate to begin with an examination of insurance activities of state-chartered banks under state law. Local conditions have led many states to authorize state-chartered banks to meet local insurance needs. State law, regulations and interpretations promulgated thereunder, court decisions and longstanding tradition permit insurance brokerage--for at least credit-related insurance--in 29 states. Ten of these states allow some amount of general insurance brokerage as well. Six states allow some amount of insurance underwriting. It is clear that the longstanding exercise of this authority neither has occasioned the dire results opponents have asserted nor has produced anything other than improved service within the granting states.

. State authority over the powers of state-chartered institutions has added a healthy degree of flexibility to our banking system. It is difficult to believe that the significant loss of flexibility and service to local communities could be justified in prohibiting activities which engender no safety and soundness risk.

The preemption of state authority in this area is not in the public interest; would cast too large a net given the current controversy; would deprive the public of services which have been offered without controversy until now; and would create unequal and unfair regulation based on organizational structure. The proposition that state-chartered banks affiliated with a holding company should be limited to the insurance activities permitted to incorporated, non-banking subsidiaries of the holding company fails to give adequate weight to both the legislative history of the Bank Holding Company Act (the "Act") and precedents within the dual banking system.

Finally, this legislation, propounded by the insurance industry to limit state authority, is unnecessary. In August of 1985, the Federal Reserve System demonstrated the scope of its authority under the current statutory scheme when it turned down an application from Citicorp to use a state's banking law to establish an insurance subsidiary, although a bank in name, for the export of insurance services interstate. The Board denied the proposal on the ground that it represented a clear evasion of the purposes of the Act.

THE HOLDING COMPANY ROLE AND REGULATION BY FUNCTION

As I stated earlier, CSBS recognizes that some expansion of bank and bank holding company roles is necessary to meet market challenges. We would oppose limiting new bank powers to the

subsidiaries of bank holding companies only, requiring conversion to the holding company format in order for a bank to benefit from deregulation. We favor allowing banks which are not already a subsidiary of a holding company to operate the new activities out of a separate subsidiary of the bank itself.

Basically, there are two arguments put forth in favor of granting new powers to bank holding company subsidiaries only: (1) the increased safety and soundness of the "Chinese Wall" and (2) the regulatory savings and use of available expertise through regulation by function.

The members of the Conference have seen no evidence that the "Chinese Wall" restrictions contained in the Bank Holding Company Act provide an effective safety and soundness barrier to institutional failure. Rather, they are "fair weather" safeguards which are all too easily ignored when failure of a major holding company subsidiary is imminent. The failure of holding companies, brought about by the failure of non-bank subsidiaries, have not been able to be kept from impacting upon subsidiary banks. To the extent that any value does derive from transaction limitations between bank and non-bank subsidiaries, those same benefits could be derived from extending similar limitations to transactions between a bank and its subsidiary and from requiring separate capitalization.

The Conference endorses the concept of regulation by function with regard to many proposed new activities including insurance and securities activities. The expertise of existing agencies should be fully utilized, the potential for duplicative and overlapping regulation and examination should be avoided and the type and level of regulation should be equal for competitors engaging in the same activities. But, again, none of the benefits of regulation by function would be enjoyed less if applied to separate bank subsidiaries.

It would be wrong, however, to think that regulation by function can take the place of "hands on" regulation for safety and soundness. Mere disclosure cannot afford the level of public confidence so necessary to the survival of our nations banking system. Where abuse of the system can result in bank failures, "after the fact" punitive measures are insufficient. The general oversight role of corporations which own bank stock is currently shared by the States and the Federal Reserve Board. No change in this scheme is required by the granting of new bank powers or the adoption of "regulation by function" for specific non-banking activities of the holding company so long as all information needed to assess the safety and soundness of the overall corporate animal is made available to the appropriate state and federal agencies.

THE NONBANK BANK LOOPHOLE

The Conference of State Bank Supervisors supports closing the "nonbank bank loophole". This legal aberration allows the circumvention of Congressionally fashioned controls over (1) the mixing of banking and commerce, (2) interstate deposit-taking,

and (3) the concentration of economic power through depository institution ownership.

The nonbank bank mechanism subverts the Bank Holding Company Act so as to achieve exactly the result the statute was designed to prevent. As the United States Supreme Court recently stated, the BHCA was enacted to accomplish two primary objectives: "... to prevent the concentration of banking resources in the hands of a few financial giants...", and "... to implement a Congressional policy against control of banking and nonbanking enterprises by a single business entity." As the Court noted, "... underlying both objectives was a desire to prevent anticompetitive tendencies in national credit markets."

As I discussed earlier, there are several public interests served by operation of the BHCA. If mere regulation as banks were sufficient to safeguard against the identified potential for public harm, passage of the BHCA by Congress and its continued existence would be superfluous. In point of fact, bank regulation alone does not reach all of the areas of public concern which must be addressed. Nonbank banks are a nationwide disruption to our system of bank structure and regulation.

To the extent that nonbank banks continue to exist, either as a result of grandfathering or the continued failure of Congress to close the loophole, companies which own nonbank banks could be placed under Fed jurisdiction for the purpose of preventing (A) any unfair method or methods of competition, (B) any unsafe or unsound practice or practices, or (C) practices inconsistent with the purposes of this Act arising out of conflicts of interest. In this way, those public harms which may arise out of circumvention of the BHCA could be policed by the Fed on a case-by-case basis. Moreover, legislation which would allow the Fed to regulate the parent company and inter-subsidiary transactions for the purpose of limiting public harm would provide a framework for the evolution of a more competitive banking system at both the state and federal levels. The ability or inability of agencies to regulate potential public harms should be the determining factor in assessing the appropriateness of intermixture of functions.

The parallels between the evolution of the interstate banking issue and the suggested approach to the commerce and banking issue are striking. In the Northeast Bancorp decision the Supreme Court upheld state imposed conditions and limitations on interstate bank ownership and rejected arguments that the Douglas Amendment was merely an "on-off" switch for interstate bank ownership. There is no reason that the bank powers question must be answered with a simple "yes" or "no". Rather, individual states, with expertise in the circumstances of local competition and the local economy, should be allowed to make an initial determination of whether the potential benefits of allowing certain inter-industry activities outweigh the potential risks, as minimized by regulation at both the federal and state levels. States could fulfill their traditional role of acting as laboratories for change, without endangering the nationwide

system. Moreover, a track record would be developed, by which to better judge the need for regulation and its effectiveness with regard to specific activities, or whether inter-mixture in these areas should be returned to forbidden status. Thereby, the degree of inter-mixture and the degree of "hands on" regulation could be adjusted, replacing our current "on-off" system of intermixture with a rheostat.

FDIC EMERGENCY ACQUISITION AUTHORITY

The broad grant of extraordinary authority sought by the FDIC in proposed legislation to date would allow circumvention of existing laws on a largely discretionary basis. It would create a strong preference for the interstate sale of problem banks interstate sale is now statutorily the least preferred alternative. While problems clearly do exist in the banking industry, sufficient authority exists under both federal and state law to accommodate the needs of FDIC.

The FDIC has not demonstrated a need for the expansion of its authority to include the interstate sale of banks in danger of closing on the basis on inadequacy of current law. State laws and regulations have provided adequate flexibility to arrange such transactions and, in several cases, have been specifically amended to accommodate the interests of the FDIC in handling failing banks. In one case, a remedial state statute was enacted within one week. It must be remembered that the interest of the state in fashioning a timely and suitable remedy to a problem situation is at least as great as that of the FDIC if not more so.

If Congress believes that added flexibility in the handling of problem banks at the federal level is desirable, the following safeguards should be made a part of such legislation:

1) A meaningful preference for intrastate acquisition, under which the FDIC may assist an intrastate transaction, as under current law, should be provided,

2) The definition of a "failing bank" eligible for emergency interstate acquisition should be strictly drawn.

3) Stockholders in the "failing" bank should be denied windfall profit-taking.

4) The threshold size of institutions eligible to be acquired should be not less than $500 million or one of the six largest banks in a state.

5) The authority to sell entire holding companies, including all healthy banks interstate, should be deleted, or alternatively, in-state bids for less than the entire BHC "package" should be favorably treated.

Last year, this Committee acted to delete the authority to arrange unassisted interstate transactions from the proposed legislation. That action improved the bill, addressing, in part, CSBS concerns over windfall profit-taking and the breadth of discretionary authority to circumvent state law. In addition, the House Banking Committee materially improved its bill by tying intrastate geographic expansion to state law. We hope that both of these changes would be incorporated into any new draft legislation, if there is to be such.

In the immediate time frame, CSBS would suggest that a bill be considered to do what needs to be done, namely renew and extend the emergency authority of the FDIC and FSLIC which has lapsed. It should be remembered that the FDIC proposals are contingency legislation, not emergency legislation. CSBS suggests that recapitalization of the FSLIC fund should not be held hostage to the broad grant of discretionary authority sought by the FDIC.

SUMMARY AND CONCLUSION

I am sure that it will not surprise the members of this Committee when I say the state banking departments throughout the country are doing their job and doing it well. We are doing our job in cooperation with our Federal counterparts, often in partnership with them. We are a part of this nation's overall system of bank regulation which Congress in great part devised.

Preemption of the State side of the ledger, whether directly or indirectly through legislative or regulatory fiat, weakens the system as a whole. Preservation of the authority of each state to determine the bank structure and products and services best suited to its own needs strengthens the system as a whole. Expediency is not a substitute for a system of checks and balances. Certainly, the Conference pledges its support in making the whole system work.

In conclusion, let me simply offer the experience and assistance of the state supervisors to you in your attempts to balance between the competing public interest concerns in this most difficult area of the law.

Thank you Mr. Chairman, members of the Committee. I would be happy to answer any questions you might have.

think a 50-percent credit rate by banks is absolutely impermissible and the States and the Federal Government should not allow that level of rate.

I am aware of the float. I am aware of the other cost increases. I have heard them on many occasions from the representatives of the banks. I also heard the argument in Connecticut how at 15 percent, the Connecticut banks would go under. Within 2 weeks of the signing of the legislation, those banks went into a rate war and didn't go only to 15 percent, they went down to 14, 13, 12, 11, and below 11 percent in order to expand their consumer base and none of them have gone out of business, Senator.

I recognize what you're saying. I know all the costs. I think the banks have not been candid in their balance sheets, at least in the data that they presented to us and probably won't be candid to you.

Senator GARN. Well, my question really went beyond that. What you want to do in Connecticut is your business. If you want to set 15, 18, or whatever, it's not my business to say that. My question is a general question of why should we be setting any rates on that kind of an instrument when people can make choices without you passing a law? I can show you banks that were only charging 13 percent when others were charging 21.

Mr. STOLBERG. My response, sir, is that we do have a commitment within a range to banks. They are within the free market and I am a supporter of the free market. I think the banks and financial institutions have a particular role. It is intertwined with government. It is not totally deregulated and probably can't and should never be totally deregulated.

I do think our commitments to our citizens demand a role in that. When my 13-year-old son continues to get every few weeks an offer from many banks of a credit card and he's told that because his credit rating is so superior they're making him this great offer, I think there's money in it and I don't think they're losing at 15 nor would they be losing at 12 today if they did it correctly.

Senator GARN. Well, I don't dispute what you say. You're still missing my point of general intrusion of government into areas where I think people ought to be allowed that right. With all the abuse of credit cards by people getting themselves in trouble, maybe we should just outlaw them. That's the point I'm trying to drive at. If we're trying to protect the consumer, why do we have all this plastic money out there? Why don't we make them pay cash?

Mr. STOLBERG. I think the banks should withdraw some of the plastic money. Indeed, part of the cost to all of us is the fact that they are offering it to 13 year olds, and sometimes maybe even issuing them.

Senator GARN. Mr. Kuthy, does the Conference of State Bank Supervisors support granting bank holding companies authority to underwrite and deal in mortgage-backed securities? I notice that you didn't mention that in your testimony.

Mr. KUTHY. I did, sir, and I probably went past it fast, but the answer is, yes, we are supportive of that. We are anxious to see some of the delineation of that power in more specific detail, but in a general way we are supportive.

Senator GARN. The CSBS clearly opposes the so-called Dodd amendment which as you know would apply insurance limitations under the Bank Holding Company Act to State-chartered subsidiaries of bank holding companies. As you also know, I disagree with that. But how does your organization view the attempt to close the South Dakota loophole but on a much less restrictive means permitting States to govern insurance activities of subsidiaries totally within their own States?

Mr. KUTHY. Clearly, we support the general proposition that each State should be able to make its own determination of insurance powers for its State-chartered banks. Our feeling on it is that we have not experienced any difficulty at the State level in those instances where that power has already been granted. Moreover, this would provide an additional opportunity for the kind of competition both in terms of price as well as service and availability.

Senator GARN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I would like to again ask of each of you relative to the savings and loan industry—and I note that neither of your States are on the map of areas that have had particularly troubled institutions—what is your diagnosis on a nationwide perspective of what has brought us to the point that we are considering this emergency action to refinance FSLIC?

AGRICULTURE AND OIL PRICE DECLINE CHALLENGE

Mr. STOLBERG. Senator, I think there are two major things that have brought us to this. One is the difficulties that the agricultural States are facing and the other is the economic challenge in the energy States. In the State budget process in all of those States they are facing major challenges and in most cases having to both reduce services and raise taxes. That's what we do at the State level. We do have to both cut services and raise taxes when we have that kind of challenge.

I think those are the two underlying reasons. I would hope that recapitalization of FSLIC, that closer scrutiny of both domestic and international lending practices, hopefully self-regulated, would contribute to the solutions. But whenever we have regional economic conditions that cause serious challenges in States, I think we can expect, even under the best of conditions, the banks are going to reflect those economic difficulties.

Mr. KUTHY. I think many of these are well publicized, Senator, in terms of the effect of rate deregulation by the Congress and the economic problems in various sectors in the economy and in various geographic areas of the country.

The disinvestment that occurred because of the inability to deregulate promptly enough in the banking and the savings and loan industries I believe as well has contributed to the sudden and disparate flows to other money market sectors of the financial industry. That combination in aggregate I believe caused much of the travail that we are visiting now, albeit those attempts that have been made or perhaps those not having been made as remedial actions in that difficult set of circumstances.

Senator GRAHAM. Mr. Stolberg, your State is in the Northeast region which was one of the first regions to provide for interstate bank mergers.

Could you assess what the current state of that process is and what has been the impact of that interstate regional banking, particularly as it relates to solidifying the economic strength of the major bank holding companies in the Northeast?

INTERSTATE BANKING

Mr. STOLBERG. Yes. As you know, Senator, we do have regional interstate. It applies on a reciprocity basis with the six other New England States. In all candor, it was probably designed as at least a temporary wall against New York and the other major national banks.

I would say it's been salutory. There is legislation filed for this session that would take it further and open it either entirely to interstate banking or phase in interstate banking.

I think thus far the process has been positive, although it's very difficult for many of us, as State legislators, to ascertain the benefit that flows to the consuming public. The interstate banking debate has largely been a debate among the banks themselves and among the bank shareholders, and that's where the major measurable gains I think have been made.

I would agree with all of the current literature. I think we will have pretty wide open interstate banking at some point in the future and I think its evolution through the 50 State laboratories is probably the correct way to go, sir.

Senator GRAHAM. One last question, going back to the first, are there any changes in Federal law or administrative actions that you would recommend we consider as a response to the diagnosis of the circumstances which have gotten the savings industry into its current state?

Mr. STOLBERG. Senator, if I had the answers to that, I would be glad to share them with you. I think they are deeply rooted. A lot of them lie I think with our fundamental problems of agricultural policy where we're the richest Nation in the world and could feed much of the world and yet our individual family farmers are facing such difficulty in so many areas.

Part of it is because of the sharp decline in interest rates, the fact that they have to live on a margin and they went into a margin at high interest times and they're having difficulty now.

The energy crisis indeed could solve itself and that aspect of the problem may not always be there.

I do think we're fortunate in the Northeast that just a few years ago when our economy was having difficulty, when we had very large deficits in our State budget processes, that we didn't encounter this. Perhaps a study of the fundamental differences between the savings and loan institutions in the Northeast and the fact that they didn't go through the major difficulty with comparable economic conditions and those in the Midwest and South and Rocky Mountain areas could prove useful.

The CHAIRMAN. Thank you very much, Senator Graham.

Thank you, gentlemen, for an excellent job. We very much appreciate your testimony. It's very helpful.

Our final panel is Mr. Charles Doyle, president of the Independent Bankers Association of America; Mr. Mark Olson, president of the American Bankers Association; Mr. John LaWare, chairman of the Association of Bank Holding Companies; Mr. Charles E. Rice, on behalf of the Coalition for Regional Banking; Mr. Dennis Kelleher, president of the Dealer Bank Association; and Mr. William Edgerly, on behalf of the Association of Reserve City Bankers.

Gentlemen, in order to deal with this financial powerhouse that is before us we will start at the right. That's appropriate for the banking industry and work to the left which is not appropriate.

Mr. Edgerly, you go right ahead.

STATEMENT OF WILLIAM S. EDGERLY, CHAIRMAN, STATE STREET BANK & TRUST CO., BOSTON, MA; ON BEHALF OF THE ASSOCIATION OF RESERVE CITY BANKERS

Mr. EDGERLY. Thank you, Mr. Chairman.

The CHAIRMAN. I might say, incidentally, you have 5 minutes and then the light will go on.

Mr. EDGERLY. Thank you, Mr. Chairman. I am William S. Edgerly, president of the State Street Bank & Trust Co. of Boston, MA. I serve as vice chairman of the payments system committee of the Association of Reserve City Bankers [ARCB], on whose behalf I appear here today.

ARCB supports efforts to modernize the Nation's financial services system. The focus of our statement will be on the payments system and its relationship to this issue. With the permission of the committee, we will be submitting a more complete statement of our views for the record in the near future.

SAFETY AND SOUNDNESS OF THE PAYMENTS SYSTEM

The need to protect the safety and soundness of the payments systems is a well recognized matter of concern of public policy. This need relates to the potential which exists for the extension of credit during the payments process. Restrictions on the business activities in which banks can engage prevent these credit risks from being created by other sectors of the economy without independent evaluations about such credit being made.

Our economy relies on the banking system to make such evaluations regarding underlying creditworthiness in the payments process.

The payments system, however, also raises important competitive issues. Today the competitive issue facing the banking industry is the inability of banks to compete more fully in offering new products and services to the public.

Our reading of well-established public policies in this country is that a major reason why banks have not been given broader opportunities to compete in the financial services marketplace is because of their involvement in the Nation's payments system. The involvement of banks in the provision of payments services—the holding and transfer of insured demand deposits—has been accompanied by a set of regulatory and supervisory restrictions, particularly those on permissible types of products and services, that have prevented banks from competing more fully in the marketplace for financial services.

These restrictions apply not only to banks but to the companies owning them. At the same time, we find the implementation of such policies to be in a state of bewildering disarray.

Some companies engage in business activities not permitted to regulated bank holding companies' own banks—the so-called nonbank banks—and thrift institutions that have the same degree of access to the payments system as full service banks.

As a result, protections against the type of payment system risks that public policy attempts to avoid through restrictions on the activities of banks do not apply in the case of these unregulated holding companies. We believe this anomaly in the regulatory treatment and therefore the competitive position of business entities similarly situated with respect to the payment system should be rationalized. We see two basic approaches which could be taken.

The first would be to apply the same regulatory requirements that apply to bank holding companies to all companies owning depository institutions that have access to the payments system.

The second and preferable approach would be to eliminate the activities, constraints, and other regulatory requirements that apply to bank holding companies so that they could compete on the same basis as all other companies owning depository institutions that have access to the payments system.

The first approach entails legislation to close the so-called nonbank bank loophole. If the loophole were not completely closed, however, and/or grandfathered companies were allowed to continue to engage in activities not permitted to banking institutions, concerns over the integrity of the payment system and the competitive imbalance between unregulated and regulated bank holding companies would be left unresolved.

To remedy this, we recommend that a prohibition be imposed on any depository relationship between the unregulated parent and holding company affiliates and the bank or thrift institutions that they own. We believe the payment system would be better protected by a prohibition against such relations than it would be by limitations on them or by limitations on the access of those depository institutions to Federal Reserve services.

An amendment to accomplish this objective is attached to our statement. Of course, no such prohibition would be needed where the relationship between a depository institution and an unaffiliated customer nor is it necessary within a regulated bank holding company where it would be redundant because of activity restrictions as well as other regulatory and supervisory requirements.

This first approach, however, does not address the fundamental need to enhance competition in the financial services sector. One particularly promising concept, we believe, is that of a financial services holding company. We believe the financial services holding company concept could be structured to protect the integrity of the payment system, thus meeting the concerns for safety and soundness which has had the effect of blocking progress so far toward increased competition.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

The **Chairman**. Thank you, Mr. Edgerly.

Mr. Doyle, the reason why we did this this way frankly was because we wanted to have the distinguished Senator from Texas, who has an intellect that all of us are in great awe of, introduce you, a man we greatly admire and respect, too.

So you're going to be next and you're going to be introduced by the Senator from Texas, Senator Gramm.

Senator **Gramm**. Mr. Chairman, I'm sorry I'm late. They just closed the Federal Government because of the snow and I was obviously celebrating with the people. [Laughter.]

I started to add that I see that the word had not reached here, but since I've conditioned my children to say when they asked at school if their pop works for the Government they say, "No, he works against the Government," I would probably count the chairman in that group and so I see why we're in session. [Laughter.]

It's my pleasure today to introduce Chuck Doyle, an independent banker in the State of Texas, a man who has proven that independent banks have a viable place in the banking marketplace by providing services, by knowing their customers, and he speaks for a very large number of people all over the country that have the perspective of customer service from an independent bank.

That he's very highly regarded in my State is obvious by the fact that he's president of the Independent Bankers.

STATEMENT OF CHARLES T. DOYLE, CEO, GULF NATIONAL BANK, TEXAS CITY, TX; PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. **Doyle**. Thank you, Senator Gramm. I appreciate that.

Mr. Chairman, it's a privilege for me to be here representing the smaller banks of the United States through the Independent Bankers Association of America.

I am from Texas City, TX. That's in the SMSA of Houston-Galveston, just south of Houston, and I am pleased that your committee plans to take early action on these key banking issues.

As you know, the banking industry shares your sense of urgency as demonstrated by a joint statement of the six major banking trade associations that was made on January 7 of this year.

But before I present my testimony, I do want to clear up a point of confusion about the joint statement. In a recent speech, Secretary Baker implied that the statement recognizes:

> That it makes sense to permit anyone to own a bank as long as insured deposits, the payments system, and the connections to the owners are regulated in a common fashion.

Let me assure you that the IBAA does not agree with Secretary Baker on this point. The statement we agreed on does not say that it makes sense to permit anyone to own a bank. Nothing could be further from the truth, as far as we're concerned.

In fact, we are concerned with the general thrust of many of the changes in the financial services industry today. In many cases, long-established policies—such as the separation of banking and commerce and limitations on interstate banking—have been sacrificed by selling off valuable franchises to assist shareholder interests or the deposit insurance funds. This approach may be attractive in the short run, but at the expense of important public policy considerations on the long term.

SUPPORT CLOSING OF LOOPHOLES

Mr. Chairman, we support your announced intention to link the closing of the nonbank bank loophole with other measures which the Department of Treasury favors such as recapitalization of FSLIC and the authorization of new powers for banks. The IBAA cannot support legislative proposals put forth in isolation which do not address the closing of the nonbank bank and nonthrift thrift loopholes.

Suppose the loopholes had not existed and the firms that now exploit them had been frustrated by the regulatory agencies in their efforts to create these loopholes.

Do you for a single instant believe that Congress would have passed legislation, say in 1982, authorizing any company—I repeat, any company—to own a federally insured bank, and would that legislation have explicitly allowed unitary thrifts to open branches in hundreds of retail stores throughout the country? Further, can you imagine a "Loophole Banking Act" providing that a bank holding company would remain under strict Federal Reserve control while loophole holding companies would escape this scrutiny? Finally, can you believe the bill would have reaffirmed the prohibitions against banking getting into new lines of business, while putting no restrictions at all on loophole holding companies?

These questions answer themselves. But that, in effect, is exactly what happened. Closing these loopholes should be your highest priority for the following reasons:

First, they breach the separation between banking and commerce.

Second, they undermine the right of States to determine their own financial structure.

Third, they give loophole holding companies uncontrolled access to the Nation's payments system.

Fourth, they are an abuse of, and a threat to, the Federal Deposit Insurance System.

Fifth, the nonbank bank loophole takes available credit away from small business and local communities. The key to most nonbank banks is that they do not make commercial loans.

FSLIC PLAN

The Treasury's plan to recapitalize the thrift industry has much to recommend it. If loopholes and the closing of them is a part of the package, we can strongly support the FSLIC plan. It contains all the right elements. Most importantly, it is based on the principle of self-help.

Of course, this will only work if the larger thrifts and the more profitable thrifts remain with the FSLIC fund. I think we need to be careful to avoid them moving to the FDIC to avoid the self-help responsibility to the FSLIC fund.

On the issue of expanded powers for bank holding companies, our convention resolution states:

> IBAA will continue to work for new means by which banks can offer competitive products and services packages, and thereby better meet customer needs. Products and services should be closely related to banking and should not expose the bank to risks that would threaten the safety and soundness of our financial system. The separation of banking and commerce test should be applied when new powers are considered.

The securities powers suggested in your letter, Mr. Chairman, meet these criteria and are a reasonable and basic extension of bank services that we now offer.

On the question of the regulators' bill, we support the original version of the bill that was adopted in 1983. Last year we questioned the need for liberalization which the regulators proposed, and given the rapid legislative response by such States as Oklahoma and Texas, we feel that the need can be met on the local State level.

In closing, I would just like to say your past leadership gives the community bankers hope for some progressive banking legislation during this 100th session and we strongly favor and support your activities.

[The complete prepared statement follows:]

STATEMENT OF WILLIAM S. EDGERLY
CHAIRMAN, STATE STREET BANK AND TRUST COMPANY
ON BEHALF OF THE ASSOCIATION OF RESERVE CITY BANKERS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JANUARY 22, 1987

I am William S. Edgerly, Chairman of State Street Bank and Trust Company, of Boston, Massachusetts. I serve as Vice Chairman of the Payments System Committee of the Association of Reserve City Bankers (ARCB), on whose behalf I appear here today.

ARCB is an organization of 400 banking executives representing the nation's major banking institutions. ARCB fully supports the efforts of the industry to seek an urgent and fundamental modernization of the nation's financial services system. The focus of our statement will be on the payments system and its relationship to this competitive issue.

The need to protect the safety and soundness of the payments system is a well-recognized matter of concern to public policy. ARCB has taken an active role in devising ways to meet this need.

The need to protect the payments system relates to the potential which exists for the extension of credit during the payments process. Restrictions on the business activities in which banks can engage do not allow this credit risks to be created by the industrial, commercial, retail and other nonbanking financial sectors of the economy without independent evaluations about such credit being made. Our economy relies on the banking system to make such evaluations regarding underlying creditworthiness in the payments process.

The payments system, however, also raises important competitive issues. Today, the competitive issue facing the banking industry is the inability of banks to compete more fully in offering new products and services to the public.

Our reading of well-established public policies in this country is that a major reason why banks have not been given broader opportunities to compete in the financial services marketplace is because of their involvement in the nation's payments system. The involvement of banks in the provision of payments services--the holding and transfer of insured demand deposits--has been accompanied by a set of regulatory and supervisory restrictions, particularly those on permissible types of products and services, that have prevented banks from competing more fully in the marketplace for financial services. These restrictions apply not only to banks but to the companies owning them.

At the same time, we find the implementation of such policies to be in a state of bewildering disarray. Some companies engaged in business activities not permitted to regulated bank holding companies own banks--the so-called "nonbank banks"--and thrift institutions that have the same degree of access to the payments system as full-service banks. As a result, protections against the type of payments system risks that public policy attempts to avoid through restrictions on the activities of banks do not apply in the case of these unregulated holding companies.

We believe this anomaly in the regulatory treatment, and therefore the competitive position, of business entities similarly situated with respect to the payments system should be rationalized. We see two basic approaches which could be taken.

The first would be to apply the same activities constraints, as well as other regulatory and supervisory requirements, applying to bank holding companies to all companies owning nonbank banks or other depository institutions that have access to the payments system. The second, and preferable approach, would be to eliminate the activities constraints and other regulatory requirements that apply to bank holding companies so that they could compete on the same basis as all other companies owning depository institutions that have access to the payments system.

The first approach entails legislation to close the so-called nonbank bank loophole. If the loophole were not completely closed, however, and/or grandfathered companies were allowed to continue to engage in activities not permitted to banking institutions, concerns over the integrity of the payments system and the competitive imbalance between unregulated and regulated bank holding companies would be left unresolved.

To remedy this we recommend that a prohibition be imposed on any depository relationship between the unregulated parent and holding company affiliates and the banks or thrift institutions that they own. We believe the payments system would be better protected by a prohibition against a depository relationship within unregulated holding companies than it would be by limitations on such relationships or by limitations on the access of those depository institutions to Federal Reserve services. It would be exceedingly difficult to monitor on an on-line basis the extension of such credit from a depository to its affiliate in the payments process. Also, practical difficulties would be encountered in monitoring a Federal Reserve account to determine whether a depository had overdrafted the account to make a payment for an affiliate. These problems could be avoided by merely prohibiting a depository relationship from existing. An amendment to accomplish this objective is attached to our statement.

Of course, no such prohibition would be needed where the relationship is between a depository institution and an unaffiliated customer. Nor is it necessary within a regulated bank holding company where it would be redundant because of activities restrictions, as well as other regulatory and supervisory requirements.

This first approach, however, does not address the fundamental need to enhance competition in the financial services sector by allowing banking institutions to offer a wider array of products and services to the public. We are mindful of proposals before the Committee to expand the list of products and services that banks can offer the public, primarily in the areas of securities, insurance and real estate. We support such initiatives as an important step in enhancing banking's competitive capabilities.

Over the long-run, however, a much more comprehensive approach may need to be taken to foster increased competition in the financial services sector. One particularly promising concept, we believe, is that of a financial services holding company.

Under this concept, a full range of financial services could be provided by the financial services holding company with the depository institutions that were part of the holding company remaining subject to current regulation. ARCB and the other banking organizations represented here today currently have such a concept under review within our respective bodies, and we have agreed to cooperate in jointly exploring it.

We believe the financial services holding company concept could be structured to protect the integrity of the payments system, thus meeting the concern for safety and soundness which has had the effect of blocking progress toward increased competition. Any measures adopted to protect the payments system could be applied to all financial services holding companies offering a wide range of services.

We are optimistic about the potential which such an approach could have for enhancing competition in the financial services marketplace. We look forward to working with the other banking organizations represented here today and with members of this Committee in pursuing this matter further during the period ahead.

ATTACHMENT A

PROHIBITION ON PAYMENT ARRANGEMENTS

(1) No depository institution affiliate of an unregulated holding company may hold any demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties for, or process payments for or on behalf of, such holding company or any of such holding company's affiliates.

(2) For purposes of this section, the following definitions apply:

(a) the term 'depository institution' means any 'depository institution' as defined in Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b));

(b) the term 'unregulated holding company' means any holding company which is not

(i) a 'bank holding company' within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841); or

(ii) a savings and loan holding company engaged only in activities permissible for a multiple savings and loan holding company under Section 408(c) of the National Housing Act (12 U.S.C. 1730a(c));

(c) the term 'process payments' means any use of depository institution, Federal Reserve Bank, Federal Home Loan Bank Board for other similar accounts for the purpose of receiving or sending payments from one party to another party;

(d) the term 'affiliate' means any company that controls a depository institution and any subsidiary of such company. The terms control, subsidiary and company have the same meaning as in Sec. 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

place very strict "holds" on a high percentage of checks. It is, I am sure, very exasperating to have to wait for access to funds that you know the financial institution will collect without trouble.

I want to point out that the majority of IBAA members provide immediate availability in most cases. This is particularly true for local checks, payroll checks, and U.S. government checks, or any check deposited into an established, rather than new account. Therefore, from an IBAA banker's viewpoint, there is no real need for Federal legislation.

We are fundamentally against imposing mandatory schedules by statute. Mandatory schedules would penalize those banks in which there is no problem. And in some cases, selective holds placed on deposits probably constitute the primary deterrent to both individuals and commercial entities from writing fraudulent checks or checks drawn on too few funds. Granting immediate availability of funds is a credit decision and should not be mandatory.

However, if there must be legislation--and we understand this Committee plans an early hearing on this question--it should direct the Federal Reserve Board, the agency responsible for the payments system, to develop workable checkhold schedules. This is the approach the Federal Reserve itself recommends. We have been opposed to the legislative schedules so far advanced because they have failed to take into account the diversity of clearing systems, the varying access to wire services, the differences in processing systems and equipment, and other differences in clearing systems across the country. Regulations developed by the Federal Reserve could take these factors into account.

There is another element that must be considered when devising checkhold limitations, and this is the risk involved for the bank. Last Congress, the House-passed bill, H.R. 2443, included a Shumway-Bartlett anti-fraud amendment. This amendment said that an institution may disregard the schedule if it "reasonably believes" that the check may not be collectable because of bankruptcy, fraud, or kiting. It required the institution to notify the depositor by the close of business the next day.

It is important that, at the very least, something similar to this be included in any new checkhold legislation. The Federal Reserve should have similar authority to suspend the schedules in order to protect financial institutions from more generalized fraud and check-kiting. These would in no way be giant loopholes permitting depository institutions to continue with "business as usual"--unless that meant rapid availability for virtually all checks. But it would protect federally-insured depositories from potential fraud.

CONCLUSION

In closing, Mr. Chairman, I would like to again thank you for your speed in calling these hearings. Those who worked with you in the past tell me to expect a very active 100th Congress for banking legislation. I very much look forward to this and certainly pledge our active cooperation.

The **Chairman**. Thank you very much, Mr. Doyle.

Our next witness will be introduced by the distinguished Senator from Florida, Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

It's my pleasure to introduce a long-time friend and close associate in many civic and economic issues in our State of Florida, a man who's provided distinguished leadership to one of our leading financial institutions, a very significant institution in the region and the Nation.

So I am proud that speaking on behalf of the Coalition for Regional Banking is Mr. Charles Rice.

STATEMENT OF CHARLES E. RICE, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BARNETT BANKS OF FLORIDA, INC.; ON BEHALF OF THE COALITION FOR REGIONAL BANKING AND ECONOMIC DEVELOPMENT

Mr. **Rice**. Thank you, Senator Graham. I'm still working on the transition of saying Senator Graham instead of Governor Graham.

STATEMENT

OF

CHARLES T. DOYLE

PRESIDENT

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

HEARINGS ON

BANKING LEGISLATION

JANUARY 22, 1987

My name is Charles T. Doyle and I am Chief Executive Officer of the Gulf National Bank in Texas City, Texas. I am also President of the Independent Bankers Association of America. IBAA is the national trade association of community banks, representing small and medium-sized banks throughout the United States.

Mr. Chairman, we are pleased that your committee plans to take early action on key banking issues, and that you have demonstrated your commitment to move quickly by calling these hearings less than three weeks into the 100th Congress. As you know, the banking industry shares your sense of urgency, as demonstrated by our joint statement of January 7, 1987.

Before I present my testimony on the points raised in your letter of invitation, Mr. Chairman, I do want to clear up a point of confusion about the joint statement. In his recent speech before the Garn Institute, Secretary Baker implied that the statement recognizes "that it makes sense to permit anyone to own a bank as long as the insured deposits, the payments system, and the connections to owners are regulated in a commom fashion." Let me assure this Committee that the IBAA does not agree with Secretary Baker on this point and the statement we agreed to does not say "that it makes sense to permit anyone to own a bank...." Nothing could be further from the truth.

In fact, we are concerned with the general thrust of many changes in the financial services industry. In many cases, long-established policies--such as the separation of banking and commerce and limitations on interstate banking--have been sacrificed by selling off valuable franchises to assist private interests or the deposit insurance funds. This approach may be attractive in the short run, but at the expense of important public policy considerations.

NONBANK BANK AND NONTHRIFT THRIFT LOOPHOLES

We strongly support Chairman Proxmire's announced intention "to link the closing of (the nonbank bank) loophole with other measures which the Department of the Treasury favors such as recapitalizing the FSLIC and authorizing new powers for banks." The IBAA cannot support legislative proposals put forward in isolation which do not address the closing of the nonbank bank and nonthrift thrift loopholes.

The recent announcement by Ford Motor Company's own thrift, First Nationwide, that it would begin opening hundreds of branches in K-Mart stores illustrates, if further illustration is needed, that the nonthrift thrift loophole is every bit as serious as the nonbank bank loophole. And, the Comptroller's recent approval of several bank applications that seek to take advantage of a District of Columbia nonbank bank loophole further points up the need to address the nonbank bank issue in all its forms.

The IBAA has testified over and over again on the need to close these loopholes. I hesitate to repeat at this point the rhetoric that we have used in these appearances. Instead, let me paint a different sort of picture. Suppose the loopholes had not existed and the firms that now exploit them had been frustrated by the regulatory agencies in their efforts to create loopholes.

Does anyone for a single instant believe that Congress would have passed legislation in, say 1982, authorizing any company--I repeat any company--to own a federally insured bank. And, would that legislation have explicitly allowed unitary thrifts to open branches in hundreds of dime stores throughout the country. Further, can anyone imagine this "Loophole Banking Act of 1982" providing that bank holding companies would remain under strict Federal Reserve control while loophole holding companies would escape any scrutiny? Finally, can you believe the bill would have reaffirmed the prohibitions against banks getting into new lines of business, while putting no restrictions on the loophole holding companies?

These questions answer themselves. But that--in effect--is exactly what Congress has done. It has decided, by failing to act, that ordinary commercial firms in any line of business may own a federally-insured loophole depository anywhere in the country. Let me outline more precisely the IBAA's objections to the nonbank bank and nonthrift thrift loopholes:

- First, they breach the separation between banking and commerce set forth in the Glass-Steagall and Bank Holding Company Acts. Anyone, from securities firms to fast-food outlets, can go into the banking business. We in this country decided long ago that credit-granting decisions should be made at arm's length by banks that have no direct ownership interest in borrowers.

- Second, they undermine the right of states to determine their own financial structure. States which have decided not to approve interstate bank ownership, and others which have provided for limited--generally regional--bank ownership, find those choices nullified by these loopholes. This right to chose was granted by Congress by the Douglas Amendment thirty years ago and reaffirmed by the Supreme Court in 1985. If it is to be taken away, Congress must do it through the front door so it can be fully debated.

- Third, they give loophole holding companies access to the nation's payments system. A small nonbank bank could incur enormous daylight overdrafts on behalf of its parent and expose the entire system to losses if the parent proved unable to meet its obligations.

- Fourth, they are an abuse of, and a threat to, the federal deposit insurance system. Federal deposit insurance was never intended to support ordinary commercial enterprises. We do not believe that the federal government should, through the deposit insurance system, guarantee the solvency of every commercial enterprise that decides to buy a bank or thrift.

- Fifth, the nonbank bank loophole takes credit away from small business. Our current system helps ensure that local money is deposited in local banks for use by, among others, local businesses. The key to most of the nonbank banks is that they do not make commercial loans. These nonbank banks take deposits of all kinds, but cannot make loans to businesses. Do we really need another kind of federally-insured, specialized financial institution with these limitations?

These concerns are not just the IBAA's. Repeatedly, Chairman Paul Volcker has implored Congress to close the nonbank bank and nonthrift thrift loopholes. And, he has pointed out some of the problems that nonbank banks--often called "consumer banks" by their supporters--raise in his mind:

> However beguilingly labeled, so-called consumer banks are essentially a device for breaching the wall that now separates banking and commerce. Those who would breach it in the presumed interest of competition and the consumer, should, it seems to me, be asked to carry a heavy burden of proof. Do we really want, for example, a retail business to be able to gather deposits under the protection of federal insurance and use those deposits to fund a credit card they sponsor more cheaply than retailing competitors? Is it wise policy to encourage banking arrangements in which a retailer has an incentive to prefer its customers in the provision of loans? Do we want to encourage joint marketing efforts and 'tie-ins' implicit or explicit?

FSLIC RECAPITALIZATION

This is the first opportunity that the IBAA has had to comment formally on the Treasury's plan to recapitalize the thrift industry. This plan has much to recommend it, and I will get to those points in a moment. However, the IBAA cannot support this plan if it means that the FSLIC will be strengthened to insure the deposits of scores of nonthrift thrifts owned by major commercial firms. The entire thrift system, including the Federal Home Loan Bank Board, the FSLIC and the Home Loan Bank system, was created to help average families obtain home mortgages, not to be the federal safety net for a Fortune 500 banking network. Unless the nonthrift thrift loophole is closed, this recapitalization plan would become a reaffirmation of loophole banking instead of a needed backstop for the thrift industry.

If loophole closing is part of the bargain, we can strongly support the Treasury's FSLIC plan. It contains all the right elements for this kind of arrangement. Most importantly, it is based on the principle of self help. In this respect, it is even better than the New York City and Chrysler assistance plans this committee passed. These required substantial sacrifices by those who got federal help, but they did get federal help. In this case, there appear to be sufficient resources within the industry to avoid an explicit taxpayer backstop.

Of course, this will only work if stronger thrifts remain in the FLSIC fund. In particular, bank holding companies that own thrifts should not be able to convert them into banks, weakening the fund just as it is recapitalized. It would be ironic if these bank/thrift combinations resulted in the exodus of the strongest thrifts.

We hope the thrifts' participation in the recapitalization program will bring home to the industry the need for, as Secretary Gould has put it, "reform like higher capital standards, appropriate supervision and generally accepted accounting principles." Any community banker can tell you that, even though the FSLIC is in trouble, savings and loans continue to take advantage of lax regulation to outbid the closely supervised banker. This has nothing to do with competition, and everything to do with unfairness.

SECURITIES POWERS

In preparing this section of the testimony, I reviewed the IBAA's resolutions adopted at our last convention. On the issue of expanded powers for bank holding companies, we said:

> IBAA will continue to work for new means by which banks can offer competitive products and services packages, and thereby better meet customer needs. Products and services should be closely related to banking and should not expose the bank to risks that would threaten the safety and soundness of our financial system. The separation of banking and commerce test should be applied when new powers are considered.

The securities powers suggested in your letter, Mr. Chairman, meet these criteria. They are, for the most part, simple extensions of services banks now offer. For example,

banks now have the power to underwrite municipal general obligation bonds, but cannot underwrite revenue bonds. Since municipalities have turned more and more to revenue bond financing, banks have been unable to fully participate in this market. There is no overriding policy reason to keep banks out of the revenue bond market, since they can already underwrite the general obligation bonds.

Similarly, large corporations do much of their borrowing in the commercial paper market. Banks may not underwrite a corporation's commercial paper, but can make loans to that same corporation. The risks are virtually the same; the only difference is in the form of the financing.

Underwriting of mortgaged-backed securities can be evaluated along the same lines. Banks may originate and hold the mortgages that are the basis for mortgage-backed securities. And, these kinds of loans are among the most secure in the marketplace. Packaging these loans and underwriting and selling the resulting securities adds no real risk to the transaction.

Finally, we agree that banks should be able to offer mutual funds. In fact, they can already offer them for retirement investments and within their trust departments. Obviously, doing this for the rest of the bank customers is not a quantum leap. And, this activity presents no additional risk to the bank. However, when banks are permitted to serve the public with this product, it will be important that we disclose that mutual funds are not protected by federal deposit insurance.

Securities Regulation and Small Banks

Though not specifically addressed in the letter of invitation to appear at this hearing, I would like to raise the issue of securities regulation of small banks. Under current law, banks with more than 500 shareholders are subject to the full panoply of SEC regulation. This imposes an arbitrary ceiling on the number of people in a community that can participate in the ownership and growth of a community bank.

This is in sharp contrast to one of the community banks' strongest competitors, the credit union. Of course, every credit union customer is an owner and is entitled to the benefits of ownership. I would like to extend these benefits to the customers of community banks. However, the 500-shareholder rule prevents this. A different standard keyed to the size of the bank, rather than the number of shareholders, would permit wider ownership of community banks and still meet the goals of the existing rule.

REGULATORS' BILL

Mr. Chairman, I appreciate the opportunity to present our views on the regulators' dramatically liberalized emergency interstate takeover proposals. While we supported the original version of the regulators' bill that Congress adopted in 1983, last year we seriously questioned the need for liberalizations which the regulators proposed last year. Given the pace of interstate banking legislation in the states and the rapid rise in mergers and acquisitions, the need for this legislation is even more questionable this year.

Before I discuss the specifics of the regulators' bill, I must strongly re-emphasize our view that the issues of emergency interstate takeovers and the closing of loopholes must be linked. The existence of thrift and bank loopholes is inconsistent with the aims of the emergency takeover provisions; unless they are closed, potential acquirers will be able to open up a brand new nonbank bank or acquire a healthy unitary thrift instead of buying a troubled institution. The nonbank bank option would permit the out-of-state bank to make a fresh start without the problem loan and management difficulties left over in the troubled bank. The market for troubled institutions could dry up completely. Therefore, Congress should not extend, much less liberalize, the emergency authorities unless it closes the bank and thrift loopholes at the same time.

A key motivating factor in the regulators' proposals is a desire to save money for the insurance funds by increasing the number of buyers for troubled institutions. This is certainly a worthy goal. However, this should not be your only goal. Diversity, the separation of banking and commerce, and local control of financial power have long been cornerstones of the country's financial and political system. In fact, the deposit insurance funds were established over the objections of the larger financial institutions to make it possible for thousands of smaller local institutions to remain strong participants in the economic lives of their communities. We urge the Congress to be sensitive to this basic policy as it considers proposals like the emergency takeover bill which would enormously increase the power of regulatory officials in Washington.

Until now, the regulators have acted as if the only way to solve their problems is to circumvent state laws. They have failed to make use of other possible solutions, such as increasing resources by including off balance sheet items and foreign deposits in the deposit base or raising assessments to increase revenues. Giving away our existing banking and thrift system to commercial enterprises and overriding state structures is not a good answer to the problem. Given the dramatic growth in the FDIC fund--from around $13 billion in 1981 to nearly $19 billion today--I seriously doubt whether a general increase in the assessment would be necessary.

Congress should closely question the need for the regulators' current proposals. To date, they have not made the case for some of their more dramatic proposals, such as lowering the threshold, changing the bank takeover standard from "failed" to "failing" and including bank holding companies in the package for emergency acquisition. Regulators have made excellent use of existing tools, and there are alternative solutions which they have not fully explored.

The Threshold

While it is possible that some liberalization of the Garn-St Germain authorities may be necessary, the regulators' proposals go too far. We oppose the arbitrary dropping of the takeover threshold from $500 to $250 million. This change alone would nearly double the number of banks exposed to interstate takeover from just over 500 to just under 1000. We have seen no facts that would justify this wholesale addition to the interstate auction block, and state legislatures have adequately addressed this issue when necessary.

When similar proposals were made in 1985, we indicated that we preferred Congress retain the $500 million threshold and provide an exemption for the four largest banks in those states with fewer than four banks over the threshold. This approach was acceptable to the then head of the FDIC.

Under this proposal, there would be at least four banks in every state of the union that could be acquired by an out-of-state organization if there were no in-state buyer. It would avoid the problem posed by a state where one of its largest banks is troubled, and yet there is no in-state buyer large enough to take it over. However, its effect would be limited to states with very few, or no, banks over the threshold. On the other hand, the regulators' blanket proposal would affect all states, even those where there are ample numbers of potential in-state acquirers. The House adopted this approach last year, by permitting the acquisition of the ten largest banks in any state; however we feel four would be adequate. We hope your Committee will adopt the provision we have suggested.

"In Danger of Closing"

The regulators have also proposed that the interstate takeover provisions be extended to banks "in danger of closing." Current law applies only to "closed" banks, which provides a significant safeguard against abuse of this authority in cases where it is not absolutely necessary.

If this safeguard is to be weakened in order to save money for the FDIC, other protections must be added. Last year's regulators' proposal lacked such protections. It simply said that a bank or bank holding company may be sold off interstate if it is "in danger of closing." Though the bill included a definition of this phrase, it was unacceptably vague. At a minimum, Congress should set specific standards for determining that a bank is in danger of closing, making clear that a bank's capital must have fallen below one percent before it can be considered "in danger of closing." Such objective standards become particularly important if there are disagreements between the regulators as to whether a bank is "failing."

Another important safeguard against abuse of the interstate takeover authority involves the role of state officials. We believe that any acquisition under the liberalized authority should not take place unless the state banking regulator in the target bank's home state has declared the bank to be failed or in danger of closing. We also believe that the target state's governor should certify that the problem cannot be handled within the state before federal officials arrange an interstate takeover. States like my own have addressed the problem in their own way. These protections would help counterbalance the increase in the number of banks exposed to interstate takeover under Federal regulations and legislation. They would encourage local initiatives on the state level. Our dual banking system must be preserved even when we face a crisis that requires emergency takeover provisions by our Federal Deposit Insurance Corporation.

We also believe that stockholders in failing banks should be discouraged from seeking an interstate solution to their problems. Unfortunately the driving force for changing banking structure and breaking down of the separation of banking and commerce has been to get a higher price for the stockholders--not because it served the public long term interest or preserved basic banking policy. In most cases involving troubled banks, there is little, if any, intrinsic value left in the bank; the only value to an out-of-state acquirer would be the interstate franchise right. Therefore, we recommend that stockholders who agree to sell their banks to an out-of-state buyer receive no compensation. When small banks fail, their stockholders don't take advantage of an interstate value and do take such a hit. If anyone gains from an acquisition under this bill, it should be the FDIC, since the taxpaying public is standing behind that fund. Last year's Senate bill largely solved this problem by deleting the "unassisted takeover" section. We hope this precedent will be followed this year.

Another way to encourage in-state solutions would be to permit in-state bidders whose ownership represents a majority of stockholders who are permanent residents of the state to rebid if their initial bid falls within 20% or $20 million of the best bid in the initial round. Comparable figures under current law are 15% and $15 million.

One serious problem with the original bidding procedure is that the FDIC must conduct the process overnight, or, at best, over a weekend. This does not give most small to medium-sized potential bidders enough time to properly evaluate the failing bank and make a prudent bid. Money center banks, on the other hand, can well afford to take the risks, especially if they are bidding for a valuable interstate franchise and market share.

This inequity should be addressed by giving the FDIC the conservatorship, or bridge bank, authority that it has requested. That would permit the agency to operate small to medium-size banks for a limited period and allow for a more orderly bidding procedure.

This Committee should ask the FDIC for specific proposals to provide greater assistance to open institutions (such as the conservatorships already utilized by the FSLIC) and to broaden the bidding process to include more banks. The FDIC should use its authority to stabilize a bank, to assist stockholders to get more capital into the bank. That, essentially, is what they did with Continental. It will work equally as well with small and medium-size banks as it has for a big bank. Why do we always have to provide that kind of help for a big bank and not for a little bank?

One feature of the operation of the emergency takeover law has been the dominance of the money center banks. Time after time they have extended their reach by acquiring institutions, particularly thrifts, in key states. We recommend that any extension of the emergency provisions include concentration limits so that a few of the very largest aggressive banking organizations will not become even more dominant. This would permit the large second tier of institutions to participate. These institutions are still rather large, but lack the market dominance enjoyed by the money center banks.

Holding Companies

The regulators' bill also puts bank holding companies on the interstate auction block if at least 33% of a holding company's banks are in danger of closing and total $250 million or more. Current law applies only to individual banks. The regulators' proposal would expose almost three thousand banks and over 500 holding companies to interstate takeover and provide out-of-state buyers with vehicles for dramatic expansion within target states. We oppose this proposal.

We do not believe that our concerns are outweighed by the difficulties of selling holding companies as individual parts. In fact, we believe that the advantages of selling parts of holding companies, or bank subsidiaries in cases of troubled individual banks, are compelling. Bank America and First Bank System are examples of bank holding companies selling branches, banks, and assets to improve operations without regulatory involvement. Also, this committee is well aware of a recent precedent for this procedure when the Chrysler Corporation sold its profitable tank division and used the capital to bolster its main auto manufacturing business. Chrysler did indeed shrink, but that was the price it paid for its federal loan guarantee.

If Congress is persuaded that it must expose holding companies to takeover, it should not adopt the very liberal tests provided in the regulators' bill. We remain unconvinced that these low asset tests are necessary or desirable. It may well be a case of regulators asking for more than they ever hope to receive. Instead, if Congress approves the acquisition of holding companies, it should adopt the $500 million threshold and require that at least 65% of the holding company's bank assets have failed, rather than the 33% standard that the regulators have proposed. Of course, the safeguards we outlined earlier in this testimony should also apply in these cases.

Expansion Rights

Finally, the bill would grant an out-of-state acquirer the same expansion rights as an in-state holding company would have in the target state's three largest metropolitan areas. This would undermine state banking laws that limit expansion to holding companies. This provision completes the undercutting of state control and simply sells advantages to the acquirer, undoing established banking policies. The bill might as well propose, that rather than using the fund for its intended purpose of paying depositors and closing banks, we will override all Federal and state policies regarding banking and allow any bidder to purchase a failed or failing bank. This is unnecessary and we hope it will be eliminated.

Thrift Acquisitions

We are also concerned about the provision in the Garn-St Germain Act which permitted "any company" to buy a failing thrift. Though this authority has not been acknowledged as a major feature of the law, if it is revived, it will be a threat to the separation of banking and commerce and inconsistent with closing the nonbank bank loophole. To ignore established policies is not in the long term interest of the safety and soundness of our financial institutions. The experience of the thrift industry deregulation results are proof positive of this fact.

SOUTH DAKOTA LOOPHOLE

Mr. Chairman, we support legislation that would close the South Dakota loophole--as strictly defined. That means state laws that grant state-chartered banks powers beyond those granted under federal law and which may be exercised only in other states. Our convention resolution makes clear that: "(T)he IBAA does not believe that any state should be permitted to export such activities outside its borders...." This is another example of seeking economic benefits by circumventing existing policies through gimmicks and loopholes. We are loosing sight of the objective of our existing financial policies both on the Federal and state level with this sort of activity.

The 1985 decision by the Federal Reserve Board denying Citicorp's application to purchase a bank in South Dakota took

much of the urgency out of the situation. In that case, Citicorp wanted to buy a state-chartered bank in South Dakota to engage in a wide range of insurance activities outside the state.

Does this mean that Congress need not act in this area? Not necessarily. Unless the loophole is closed by statute, the Fed's stance could be succesfully challenged, and other states might be tempted to pass laws exporting new powers. It would be prudent for Congress to clarify the situation.

However, such legislation should simply prohibit the export of state authorized services not permitted by federal law. Legislation closing the loophole should not go beyond that simple goal and compromise useful state authorities.

States should retain their traditional role in the country's financial system. As our convention resolution said, "The dual banking system performs a valuable function by permitting states to be intrastate laboratories for change in banking-related products and services."

Unfortunately, the legislation that has been proposed to date on this issue has gone far beyond what is necessary to close the South Dakota loophole. Most visibly, the insurance industry has avidly sought language which would bar state authorized insurance activities of bank holding company affiliates and subsidiaries, including state-chartered banks. This would apply whether the activity is conducted out-of-state or strictly within the institution's own state. It would create a precedent of federal limits on state chartered banks that would undermine the dual banking system.

Obviously, the insurance industry has used the controversy over South Dakota's statute to seek a victory at the federal level in battles it fears it may lose, or has already lost, in state legislatures. For an industry that has fought federal regulation at every turn, that is a remarkable stance.

If Congress wants to close the South Dakota loophole, then it should do so. But it should not use that legislation as an excuse to undermine the dual banking system and the ability of states to conduct reasonable experimentation within their borders. Many states have for years authorized their banks to offer insurance services. These operations should not be arbitrarily closed down without any evidence that they are harmful or discriminatory.

CHECKHOLD LEGISLATION

I understand the concerns many have with the checkholding practices of some financial institutions. I was frankly surprised to hear that in Washington, D.C. and other urban centers, many banks, thrifts, and credit unions still routinely

Mr. Chairman and other members of the committee, I'd like to briefly state the Coalition's position in the five areas specified in the committee's invitation.

A subject that should receive prompt attention is the proposal or the several proposals—any one of the several proposals—we're not experts on which one—to recapitalize FSLIC. Although a majority of thrifts today operate profitably, and that statement was made by Chairman Gray yesterday, and they serve their communities well, a minority are straining the system and recapitalization of the fund would appear to be a necessity.

We further believe that healthy thrifts which did not contribute to the problem should not be held captive to an undercapitalized FSLIC by imposition of huge and unrestrained exit fees or through administratively created barriers.

The banking industry will, however, continue to caution against fallback positions such as the merger of the FDIC and FSLIC.

VIEWS ON REGULATORS' BILL

On the second issue that we were invited to comment on, that of additional authority for Federal regulation to assist troubled institutions as proposed in the regulators' bill, we suggest the following: A 1-year time limit on emergency powers; retention of the $500 million asset threshold with an exemption for the five largest banks in those States with fewer than five banks over the threshold; the requirement that 2 years elapse before an out-of-State acquirer is allowed to purchase in-State institutions or to otherwise expand geographically within the State.

We also think there should be greater review of whether emergency legislation should be expanded to include failing rather than failed institutions and whether assistance should be provided to holding companies rather than limited to banks.

The third issue, closure of the nonbank bank loophole, is one on which we believe Congress should act promptly and that is a priority of the Coalition. We expressly supported Chairman Proxmire's efforts in the last Congress to do this and we now believe that legislation is critical.

As we see it, the key issue is who may own nonbanks because ownership determines regulation and supervision and therefore safety and soundness. At the heart of this, as has been stated earlier this morning, is the separation of commerce and banking. Allowing commercial entities to breach the longstanding public policy of separation will undoubtedly increase conflicts.

Unregulated expansion of commercial entities into banking can only undermine confidence in and the overall safety and soundness of our Nation's financial system. A nonbank parent whose nonbank subsidiary is insured by the FDIC must not be allowed to avoid rules or restrictions that a bank's parent must follow under the Bank Holding Company Act.

We urge reestablishing a clear definition of a bank and that any grandfather date for nonbank banks be as early in time as feasible in order to get the necessary support for passage for closure of the nonbank bank loophole.

At our own company our concern over nonbanks led us to join with the IBAA in successful litigation against the Comptroller of the Currency on this issue. We also successfully joined others in our home State to convince the Florida Legislature and then Governor Graham to prohibit nonbank banks under State law.

As you undoubtedly know, our litigation resulted in a temporary injunction against the Comptroller prohibiting his office from issuing a national bank charter to a nonbank bank. That injunction has been in effect for about 2 years.

As you are also aware, a motion to dismiss that injunction was filed just last month by the Comptroller of the Currency, creating, we believe, urgency for legislation on this matter.

Nonbank banks are not devices brought about by unattended needs or concerns. Rather, they are creations intended to bypass existing law and regulation. They are sponsored either by banking firms seeking to enter States from which they are otherwise prohibited or by commercial firms which want deposit-taking powers and access to the payment system unrestricted by the Bank Holding Company Act or other applicable Federal regulations.

Closing the nonbank bank loophole is our top priority for the Congress in this session and we believe that the issue must be finally resolved at the congressional level and only then will Congress be able to move ahead and address the other issues that are facing banking today.

On the subject of banking powers in light of today's changing financial marketplace and increased competition, we support allowing expanded products and services, specifically municipal bond underwriting, mortgage-backed securities, commercial paper, and mutual funds.

Finally, our group does not believe check hold legislation is necessary at this time. Very few checks are held, 3 out of every 10,000.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

The CHAIRMAN. Thank you very much, Mr. Rice.
Next, Mr. Kelleher.

STATEMENT OF DENNIS J. KELLEHER, FIRST VICE PRESIDENT OF THE BANK OF BOSTON, ON BEHALF OF THE DEALER BANK ASSOCIATION

Mr. KELLEHER. Mr. Chairman and members of the committee, I am Dennis Kelleher, first vice president of the Bank of Boston. I appear before you today as president of the Dealer Bank Association, a trade association of 182 commercial banks and their affiliates, of all sizes and from all parts of the country, that are active in the national and international securities markets.

Since our association was formed in 1972, we have worked with this committee and its staff on a wide variety of matters, and we have consistently supported the chairman's efforts to permit commercial banking institutions to underwrite and deal in municipal revenue bonds. We appreciate the efforts of the chairman and Senator Garn in this regard.

UNDERWRITING REVENUE BONDS

Despite our efforts and those of the committee, however, banks are still barred from underwriting revenue bonds. During the years that we have been pursuing this limited goal, there have been dramatic technological and other changes in the marketplace. For example: Global securities trading has become a reality, giving United States companies the ability to be served by foreign markets that are more competitive than our domestic markets; asset-backed securities now provide funding for mortgages and consumer credit in ways not mentioned or thought of in 1972; commercial paper has become the short-term funding mechanism of choice for the higher quality credits; mutual fund ownership by individuals has increased enormously; securities firms have developed what amount to deposit instruments for their retail customers; a major Japanese bank has bought into one of our leading investment banking firms; tax law changes have altered the nature of the municipal bond markets; and insurance companies, automobile companies, securities firms, and others have acquired federally insured depository institutions and have expanded their operations.

In short, the financial world has changed a great deal in the last 15 years, and the rate of change is accelerating. While the authority to underwrite and deal in municipal revenue bonds is still important to our members in this new environment, it is now essential as a matter of public policy and the maintenance of a sound banking system to consider more fundamental changes in our Nation's financial institution structure. That is why, as explained in my written statement, we support proposals that would permit a financial holding company to own both a full-service commercial bank and a separately capitalized, full-service securities firm. This would, we believe, allow full and fair competition, subject to appropriate regulation in the public interest.

There is no question, Mr. Chairman, that fundamental reform is critically needed. Just consider for a moment some of the anomalies that the existing legal jigsaw has produced:

One of the world's largest retailers of general merchandise owns an FDIC-insured bank; a savings and loan association; a full service real estate company; a full service insurance company; and a full service securities firm. U.S. bank holding companies are restricted from all but a few of these activities.

Fifteen large foreign banks can own full service securities firms in this country—firms that can underwrite and deal in U.S. corporate securities. U.S. banks or bank holding companies cannot.

U.S. banking institutions can and do safely and profitably underwrite U.S. corporate debt and equity securities through subsidiaries overseas; yet they cannot engage in that activity here in the United States.

Several investment banking firms now own FDIC-insured banks that could offer FDIC insured certificates of deposit, make commercial loans, and issue letters of credit. Thus, securities firms can and do exercise major banking powers.

U.S. banking institutions underwrite and deal safely and profitably in trillions of dollars of United States and municipal securities annually, yet they cannot underwrite most investment grade municipal revenue bonds.

Until Congress acts to straighten out this mishmash, the outlook is for even greater confusion in the provision of financial services, accompanied by even more litigation. That cannot be the course that best serves the public interest.

Agreement on this point is widespread, extending even into the securities industry. While that industry's trade associations will trot out the hoary shield of Glass-Steagall at the sound of a gavel, recent statements by American Express and other industry leaders reflect a weariness with the party-line, and a recognition that public policy and marketplace reality require comprehensive legislative change. This is welcome progress and hopefully will lay the foundation for fundamental reform legislation in this Congress.

We recognize the difficulty of structuring and passing legislation that really does modernize our financial institution structure. But we respectfully suggest that a piecemeal approach is inadequate in light of the marketplace reality—and a piecemeal approach has not worked as a practical matter in the Congress over the last many years in any event. We, therefore, urge a comprehensive focus for this committee.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

CHARLES E. RICE
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
BARNETT BANKS OF FLORIDA, INC.

Mr. Chairman and members of the Committee, I am Charles E. Rice, Chairman and Chief Executive Officer of Barnett Banks of Florida, Inc. We are headquartered in Jacksonville and have 35 individual banks in 457 offices in Florida and Georgia. We are a 110-year-old banking organization, with assets exceeding $20 billion.

Today, I also represent the Coalition for Regional Banking and Economic Development, formed four years ago out of a consensus that geographic banking expansion was best addressed at the state level. Our Coalition firmly believes in the dual banking system and the rights of states to influence the structure of banks within their borders.

Actions taken to date by various states have resulted in progress toward regional economic development. Since the U.S. Supreme Court's *Northeast Bancorp* decision, there has been steady and safe expansion of banking services. Congressional wisdom not to prematurely compel interstate banking has fostered progress within the regions.

Now, let me briefly state the Coalition's position in the five areas specified by the Committee's invitation.

First, we support the Administration Plan to recapitalize the FSLIC, but we oppose merging FSLIC into the FDIC, and we urge that FSLIC be restrained from penalizing, or creating barriers to frustrate, an insured thrift's right to convert to an FDIC-insured bank.

Second, while we are willing to support the so-called "Regulators' Bill," we question whether there is any urgent need for it.

Third, we strongly support closing the nonbank bank loophole, and have made this our top legislative priority for 1987.

Fourth, we support new product and service authorities for banking organizations and enthusiastically endorse proposed new authorities to deal in, underwrite or distribute commercial paper, municipal revenue bonds, mortgage-backed securities and mutual funds.

Finally, we do not believe any need has been demonstrated at this time for check-hold legislation. However, if the committee moves ahead in this area, we would urge that the Federal Reserve be given both a principal role in administering the program and sufficient time to develop it.

Now, I would like to briefly discuss each of these in order.

A subject that should receive prompt attention is the Administration's proposal to recapitalize FSLIC. Although a majority of thrifts today operate profitably and serve their communities well, a minority are straining the system, and recapitalization of the fund is therefore a necessary step.

Further, we believe healthy thrifts, which did not contribute to the problem, should not be held captive to an undercapitalized FSLIC by imposition of huge and unrestrained exit fees or through administratively created barriers.

The banking industry will, however, continue to caution against back-up schemes that would merge the FDIC and FSLIC, in the event the thrift fund is not recapitalized.

On the second issue, that of additional authority for federal regulators to assist troubled institutions, as proposed in the "Regulators' Bill," we suggest the following:

- A one-year time limit on emergency powers.
- Retention of the $500-million-asset threshold, with an exemption for the five largest banks in those states with fewer than five banks over the threshold; and,
- The requirement that two years elapse before an out-of-state acquiror is allowed to purchase in-state institutions or to otherwise expand geographically within the state.

We also think there should be greater review of whether emergency legislation should be expanded to include "failing" rather than "failed" institutions and whether assistance should be provided to holding companies rather than troubled banks.

The third issue, closure of the nonbank bank loophole, is one we believe this Congress should act on promptly. We expressly supported Chairman Proxmire's efforts in the last Congress to do this, and we believe the need to legislate is critical now.

As we see it, the key issue is who may own them, because ownership determines regulation and supervision, or, if you will, safety and soundness.

At the heart of this is the separation of commerce and banking. Allowing commercial entities to breach the longstanding public policy of separation will undoubtedly create conflicts.

Unregulated expansion of commercial entities into banking can only undermine confidence in -- and the overall safety and soundness of -- our nation's financial system. A nonbank parent, whose nonbank subsidiary is insured by the FDIC, must not be allowed to avoid rules or restrictions that a bank's parent must follow under the Bank Holding Company Act.

We urge reestablishing a clear definition of a bank, and that any grandfather date for nonbanks be as early in time as is feasible.

At Barnett, our concern over nonbanks led us to join the IBAA in litigation against the Comptroller of the Currency on the issue. We also successfully joined others in our home state to convince the Florida Legislature and Governor to prohibit nonbank banks under state law.

Nonbank banks are not devices brought about by unattended needs or concerns. Rather, they are creations intended to bypass existing law and regulation. They are sponsored either by banking firms seeking to enter states from which they are otherwise prohibited, or by commercial firms which want deposit-taking powers and access to the payment system, unrestricted by the Bank Holding Company Act or other applicable federal regulation.

Closing the nonbank loophole is the Coalition's top priority, and we believe that the issue must be finally resolved at the national level, and only then will Congress be able to move ahead and address other issues facing this Committee.

On the subject of increased banking powers, in light of today's changing financial marketplace and increased competition, we strongly support allowing expanded products and services. We would specifically endorse the authority for banks to deal in, underwrite or distribute:

- Municipal revenue bonds;
- Mortgage-backed securities;
- Commercial paper; and
- Mutual funds.

As you are aware, three of these products were in the 1984 legislation which so overwhelmingly passed the full Senate. Our banks must have new tools that will allow us to remain competitive.

Of course, we recognize that to the extent segregation between banking and commerce is relaxed, there is an enhanced need for uniform regulation and supervision of all institutions offering financial services.

Finally, our group does not believe check-hold legislation is necessary at this time. Studies such as those by the American Bankers Association and the California Superintendent of Banks show holds are placed on only three out of every 10,000 checks. Based on such a record, we do not believe a significant problem exists.

Selective holds placed on deposits constitute a primary deterrent against fraudulent checks or checks drawn on insufficient funds. Without this deterrent, the number of checks returned unpaid after both the first and second presentments would greatly increase.

However, if the Committee intends to act in this area, we urge that the Federal Reserve be allowed at least sufficient time to adopt and implement a national program.

Mr. Chairman, we hope your Committee will promptly consider these issues. The time has come for Congress to express its will and correct the judicial and regulatory confusion that has emerged and compounded during the last four years. We look forward to working with you and the Committee on these crucial issues.

Thank you.

STATEMENT OF DENNIS J. KELLEHER
ON BEHALF OF THE
DEALER BANK ASSOCIATION
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JANUARY 22, 1987

Mr. Chairman and Members of the Committee:

I am Dennis Kelleher, First Vice President of the Bank of Boston. I appear before you today as President of the Dealer Bank Association, a trade association of 182 commercial banks and their affiliates, of all sizes and from all parts of the country, that are active in the national and international securities markets.

The DBA is delighted that this Committee in the early days of the 100th Congress is turning its attention to the unfinished business of the last Congress. Of particular interest to our members is legislation to expand the permissible securities activities of bank holding company subsidiaries. We hope that, in addition to that legislation as it was framed in the last Congress, the Committee will focus on the broader needs of the financial markets and on the appropriate roles of the participants in those markets.

Since 1973, there have been continuous changes and technological advances affecting our financial market structure.

Sears is now a major participant in those markets with broader overall powers than banking institutions such as Citicorp and Chase. The securities industry is still using the hoary shield of the Glass Steagall Act to escape bank competition. The Federal Reserve Board had recent occasion to observe: "The Board believes that the public interest in promoting competition, meeting consumer needs, and safeguarding the safety and soundness of the banking system will not be optimally served by attempting to fit today's markedly different financial markets into the fifty year old Glass Steagall Procrustean bed. . . . The Board again wishes to take this opportunity to express its strong recommendation that the Congress act on these [Glass-Steagall] and other banking issues as early as possible in the next Congress."[1]

Although, when it was enacted over 50 years ago it was not viewed as such, Glass Steagall functions today as essentially an anti-competitive measure in that it prevents legitimate and vigorous competition in the securities and banking industries. In the words of this Committee, when considering authorizing commercial banks to underwrite revenue bonds: "Although it is often difficult to measure precisely the effect of increased competition, in our free enterprise economy there must be a presumption that competition is to be preferred to the absence of competition. Thus, those who would restrict competition have the burden of demonstrating that competition will not in fact reduce costs or that the direct cost savings would be offset by socially undesirable externalities."2/

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[1] Federal Reserve Board, Press Release, December 24, 1986, p. 7-8.

In the 99th and I believe all previous Congresses going back at least to 1963, bills have been introduced to add commercial bank competition to various elements of the securities markets. Although a number of those bills have been passed by the Senate they have always died in the House of Representatives. In the 99th Congress, Senator Garn's omnibus bill would have permitted bank holding subsidiaries to underwrite and make markets in municipal revenue bonds, commercial paper, mortgage backed securities and mutual funds.

We supported and continue to support that limited expansion of the securities activities of bank holding company subsidiaries. But at the same time, we urge this Committee -- as the bank regulatory agencies have done -- to look at the broader problems caused by "attempting to fit today's markedly different financial markets into the fifty year old Glass Steagall Procrustean bed."3/

2/ Sen. Report No. 93-1120, 93d Cong., 2d Sess. 1974, p. 13.

3/ Federal Reserve Board, Press Release, December 24, 1986, p.7.

We have provided the Committee, for the record, two documents that we believe set forth the problems of trying to apply Glass Steagall to today's marketplace. One is the J.P. Morgan study entitled "Rethinking Glass-Steagall." The Committee and its staff will find here a perceptive analysis of the history of Glass-Steagall and the reasons the Act represents poor public policy under modern market and regulatory conditions. The other document is a book entitled "Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market." This book contains market, statistical and historical analyses conducted by academic and other experts under the auspices of the Salomon Brothers Center for the Study of Financial Institutions at New York University. The conclusion of the year-long study was that the repeal of Glass-Steagall "would materially benefit the U.S. banking system and national economy."

Public Policy Objectives Of Financial Institution Legislation

We start from the premise that those who support changing the current system -- as we do -- have to show why change serves the goals of sound public policy. Those who oppose change have a similar burden. The strength of our financial system is too important to our country's economic development to allow those protected from competition by present law to avoid confronting the public policy issues by repeating their old, tired, selfish arguments.

We think that there are four major public policy goals that the Congress should keep in mind in developing new financial institution legislation:

First, the legislation must protect and enhance the safety and soundness of the financial institution system. The public policy focus must be on systemic strength, not the protection of the shareholders of any particular institution against losses. We suggest that the banking component of the system requires attention at this time because banks and their holding companies are uniquely restricted in their ability to diversify activities and risk, to use capital efficiently, and to serve the needs of their individual and business customers as market developments dictate. The result of these restrictions is to impair the long-term viability of banking institutions; put another way, the restrictions, though designed to make banks and their holding companies safer institutions, actually make them riskier institutions. Higher risk banks necessarily mean higher risks for the federal insurance funds and the payments system.

Second, the legislation must promote economic efficiency. The fundamental premise of our economic system is that competition serves the public interest by promoting economic efficiency. Financial institution legislation must therefore increase competition. In our competitive and inter-dependent world -- a world in which other major economic powers, including our neighbor Canada, are rapidly lowering barriers to competition in their own countries -- the United States cannot maintain its preeminent position with arbitrary and out-dated barriers to competition in our domestic markets.

Increasing competition for the full range of financial activities would bring better services, better products, and better prices to consumers of financial services in the United States. And all of us -- individuals, home owners, small businesses, large corporations, and governments -- are necessarily consumers of financial services today, whenever we make a deposit, take a loan, use a credit card, buy or sell a security, plan for our retirement or decide how much and what kind of insurance we need to protect our families or businesses.

The public policy goal of economic efficiency also means that financial institution legislation must prevent one industry sector from gaining an unfair -- that is, unearned -- competitive advantage because of tax, regulatory or other legal privileges. It means that anti-competitive concentrations of market power and the exploitation of potential conflicts of interest must be prohibited, and that an effective regulatory structure must be in place to enforce the rules that assure that competition is fair as well as full.

Third, the legislation must assure that financial institutions have the flexibility to respond to developments in the financial marketplace -- a marketplace in which technological innovation is almost daily providing new ways to deliver financial services to individuals and to businesses, a marketplace that is increasingly international in scope, a marketplace in which individuals and businesses alike have become remarkably sophisticated about the alternative financial intermediaries and services available to them. As Merrill Lynch recently said in a filing by its non-bank bank seeking relief from some unnecessarily restrictive FDIC rules:

> "In recent years, changes in technology and consumer preferences have stimulated the development of a financial services industry in the United States -- an industry whose diversified participants offer financial services to consumers in combinations that cross traditional commercial lines . . . . The development of a financial services industry is healthy. Not only does it respond to consumer demands, but it introduces new competition and new ways of competing that contribute to more efficiency in the economy, better satisfaction of consumer needs and lower customer costs for a range of financial services."

The pace of technological and market innovation means that new financial institution legislation must be flexible; it should not repeat the mistakes of the past by attempting artificially to cabin the activities of particular types of institutions in an effort to mold a political compromise.

Fourth, the legislation should establish a sensible federal regulatory structure for financial institutions. In some sense, this is not a separate public policy goal itself, but a necessary element in achieving the goals of safety and soundness, economic efficiency, and responsiveness to market developments. But regulatory structure is so important an element in achieving those other public policy goals that we think it deserves special attention. We are not at all sure that a whole new regulatory system is needed, or that drawing new boxes and lines on a chart will make any difference in the quality of federal regulation or the public confidence it inspires. The critical public policy elements in a regulatory structure are clear and comprehensive legislation, elimination of unnecessary restrictions on activities of holding company subsidiaries, and sufficient resources to carry out the regulators' examination and enforcement responsibilities efficiently and effectively.

We recognize that there is some degree of tension among the public policy goals we have identified. Conflicting goals are possible whenever Congress considers how to protect the public interest in the efficient operation of private enterprises that are subject to federal regulation. But we think there is no fundamental conflict among the goals in this instance; in fact, we think that in many ways the goals we have laid out are complementary. The goal of protecting the safety and soundness of the financial institution system, for example, requires both flexibility to respond to market developments and an effective regulatory structure, and is, in our view, fully consistent with the goal of economic efficiency.

Failure Of Existing Legislation To Meet The Public Policy Goals

We think that there can hardly be any serious debate that existing legislation -- much of it passed 50 years ago under dramatically different market and regulatory circumstances -- fails to meet the public policy goals toward which we ought to be striving.

Take first the critical goal of safety and soundness. The existing limitations on bank securities activities, though intended to protect safety and soundness, actually weaken the banking system. The Comptroller of the Currency, for example, has testified that the Glass-Steagall restrictions reduce "the ability of the banking industry to liquify its assets, diversify its loan portfolio . . . provide credit services to high-quality borrowers . . . [and] develop new income sources through the offering of new products." Relaxing these restrictions, as the FDIC has pointed out, would improve safety and soundness, both because the risks of securities underwriting are "lower than with many types of commercial lending" and because allowing banking institutions to diversify their activities would make them "less vulnerable to economic ups and downs." Diversification is particularly important for smaller banking institutions because, as the Comptroller has said, they "may be dependent on the economy of a particular area" and therefore not able to obtain a high quality loan portfolio without increased securitization of banking system assets.

My point can perhaps be made this way: if all a bank can do is make loans, and if the best corporate credits are moving away from bank loans to securities (as the Committee well knows is the case), then the bank will be driven toward lower quality loans. Banks today are clearly losing market share to other providers of credit, including particularly the securities markets. In 1965, for example, 86% of short-term corporate credit came from commercial banks, while in 1985, only 68% did. There was a similar reduction in the portion of overall private sector lending done by banks: in 1982, U.S. commercial banks accounted for 23.5% of such lending, but by 1985, just three years later, the bank share had dropped to 16.1%. As Under Secretary Gould has testified, weak banks "translate into weak deposit insurance funds" and rob the country of "a valuable and vital business that can help consumers, small savers, American industry, and our international competitiveness."

In short, the goal of safety and soundess is undermined by existing law. An essential element in improving the safety and soundness of the financial system is to remove the existing legal barriers to diversification.

The public policy goal of economic efficiency is also undermined by existing legal barriers. It is not economically efficient to have laws that prohibit U.S. banking institutions from underwriting the bonds of U.S. corporations here, even though U.S. banking institutions can and do successfully underwrite the bonds of U.S. corporations when issued in Europe. It is not economically efficient to have laws that prevent U.S. banking institutions from underwriting some kinds of state and local revenue bonds, even though U.S. banking institutions can and do successfully underwrite other kinds of revenue bonds and all types of general obligation bonds. There are many other examples. In each such situation, we are wasting available human, technological and capital resources that could be used to make the U.S. financial markets more efficient, to the benefit of all those who use financial services.

The effect of the existing legal barriers to competition is unnecessarily high concentration ratios in those portions of the capital markets from which banks are excluded. The four leading securities firms control two-thirds of the domestic mortgage-related securities market. In that part of the municipal revenue bond market from which banks are excluded, the top ten underwriters control 57% of the market, while in the municipal general obligation bond market, where banks can compete, the top ten underwriters account for only 31% of the market. The corporate debt market is dominated by one investment bank that controlled 22% of the underwritings in 1985. These high concentration ratios mean that it costs more than economically necessary to issue and trade in securities.

While all issuers of securities will benefit from increased competition, the benefits of additional competition will be especially valuable to regional and local business. As the National Association of Securities Dealers has concluded:

> "One of the more ominous problems confronting small business financing is the contraction of the broker/dealer community and the increased concentration of business activity into larger firms. The existence of regional, locally-oriented firms to underwrite the issues of small businesses is essential if such businesses are to gain access to the public markets."

Banking institutions can and will serve the needs of small and regional business when they are allowed to compete fully and fairly against securities firms.

Full and fair competition also means allowing financial institutions to compete with each other to serve the customer without limitations based solely on the type of institution. Securities firms today can own FDIC-insured banks -- and so long as the bank either refrains from taking demand deposits or refrains from making commercial loans, the practice is lawful. Goldman, Sachs & Co.'s application to establish Broad Street Bank & Trust in Massachusetts has recently been approved. It told the state regulators that it wanted to offer its customers "a full range of financing alternatives" -- including FDIC-insured certificates of deposit -- through the combined efforts of "Goldman, Sachs & Co. and Broad Street." If it is sensible and proper for

Goldman, Sachs to serve customer needs this way, it is surely sensible and proper for banking institutions to have the same rights to compete for business.

Our third public policy goal is assuring flexibility to respond to marketplace developments. Existing law fails on this ground too. Perhaps the most compelling example is the development of the commercial paper market. There was a time when making short-term loans to highly creditworthy corporations was a major element of the commercial banking business. But today the best credits use the commercial paper market. Between 1980 and 1985, commercial paper outstanding increased 143%, while commercial and industrial loans increased only 51%. From a public policy perspective, there is some good in this development: commercial paper lowers the costs to the borrower, though not as much as if banking institutions could compete too. But Glass-Steagall creates a major public policy problem: banks are excluded from underwriting and dealing in commercial paper. Today, they can act only as a placement agent for a commercial paper issuer. This means that banks cannot serve the customers they once served, and cannot earn the income they once earned from providing short-term credit to quality corporate borrowers. The existing system, in other words, is too inflexible to permit banking institutions to remain healthy and competitive.

Let me give one more example of the problem of inflexibility under current law. Suppose you are the chief financial officer of a major U.S. corporation that needs intermediate-term credit. You have many choices: a loan from domestic or foreign banks, insurance companies, pension funds or other institutional investors, or some combination of them through syndication or loan participation; the issuance of bonds in the U.S. by private placement or in a public offering; or the issuance of bonds in the Euromarket. Your U.S. bank can provide all of these services to you save one: the public issuance in the United States of corporate debt securities. You can get that service, plus all the others, through several U.S. broker/dealer firms and their affiliated banks and insurance companies, and, ironically, from several foreign banking institutions in the United States, but you cannot get it from your U.S. bank or its affiliates. This result simply makes no economic sense.

The fourth public policy goal is a sensible federal regulatory structure. To us, this means principally regulation by function. We think that underwriting and dealing in securities should be regulated by the SEC, whether the securities dealer is owned by a bank holding company, a diversified financial services company, or the partners of a securities firm. We think that banking activities should be regulated by the banking regulators, regardless of who owns the bank. We also think that a sensible regulatory structure recognizes the legal and

If the securities industry trade association would follow the constructive lead of these major members, we and they could work together on constructive new legislation, rather than fighting each other and making Congress' job more difficult. If the result of our cooperation were progressive new legislation, all consumers of financial services would be the beneficiaries.

Conclusion

As is evident from my testimony, the Dealer Bank Association believes that the time has come for a fundamental revision of our financial institution legislation. We believe that the core concept for new legislation should be the authority of subsidiaries of holding companies to engage, under appropriate functional regulation, in a variety of financial activities, including specifically full-service banking activities and all securities underwriting and dealing activities. We hope that the Congress will move promptly toward the consideration of legislation to accomplish that goal.

Thank you.

The **CHAIRMAN**. Thank you, Mr. Kelleher.

Mr. LaWare.

STATEMENT OF JOHN P. LAWARE, CHAIRMAN, ASSOCIATION OF BANK HOLDING COMPANIES

Mr. **LAWARE**. Mr. Chairman, I am John P. LaWare. I am chairman of the Shawmut Corp. which is a Boston-based bank holding company and I am here today in my capacity as chairman of the Association of Bank Holding Companies.

Mr. Chairman, you and the distinguished gentleman from Utah have both made valiant efforts to legislate needed changes in banking laws to create more competition for financial services companies. In spite of strong support for your efforts here in the Senate, the other body has not seen fit to join you in improving the competitive balance among financial services companies to the advantage of consumers and the entire economy.

Several years of drought in terms of constructive banking legislation, including the failure to pass the urgently needed regulators' bill and even more important recapitalization of the FSLIC, have generated enormous frustration among bankers, to say nothing of what you and your colleagues must feel.

Among bankers, that frustration has triggered some perhaps belated self-analysis in an effort to understand why intelligently designed legislation fails to pass. We conclude that there are two principal reasons.

BANK PROPOSAL HAVE BEEN TOO ONE-SIDED

The first is that the proposals of the banks in the past may have been too one-sided. We have repeatedly sought freedom to participate in other segments of the financial services industry such as securities underwriting and brokerage, mutual fund sponsorship, management and distribution, insurance brokerage and underwriting, and real estate development, management and brokerage.

Quite naturally, those engaged in those activities see our request as an invasion of their lunch table without even bringing dessert. As a result, our program has been almost universally opposed by all other financial service segments.

The second reason for the failure is the legitimate public policy concern for the safety and soundness of federally insured depository institutions. The hypothetical scenario driving that concern is that additional authorized activities for bank holding companies would be too generously funded by the insured banks and the hypothetical failure of an affiliate could weaken the insured bank or even cause it to fail.

Assuming that these are the reasons, we have failed to get broad support for additional activities for banks. We set about finding a new approach which would address both problems. We believe very strongly that the proposal you have before you for a new entity, the financial services holding company, addresses both the competitive issue and the concern for safety and soundness.

A financial services holding company could engage in any financial service through a subsidiary as long as federally insured depository institutions it controls are in a subsidiary insulated from sister subsidiaries as to funding or transfer of capital.

This banking subsidiary, whether a single bank or a bank holding company, would be subject to regulation just as it has in the past. Similarly, the sister subsidiaries would be subject to whatever regulation Federal or State law presently imposes as well as the dictates of the marketplace as to capitalization and sources of funding.

For example, let us imagine a financial services holding company with three subsidiaries; one, a bank holding company owning a federally chartered commercial bank; two, an investment bank and brokerage concern; and three, an insurance company. The national bank would be regulated by the Comptroller of the Currency and his deposits insured by the FDIC. The investment bank and brokerage concern would be regulated by the Securities and Exchange Commission. The insurance company would be subject to regulation by the insurance departments of the various States in which it has to do business.

In this way, banks and bank holding companies could expand into other financial services without threatening their safety and soundness. By the same token, other financial service entities could engage in banking through a federally chartered institution and a federally insured institution as long as they were willing to isolate that activity in a separate insulated subsidiary.

It is our hope that this new approach offering banks access to other financial businesses and providing others with a way to own a bank will provide common ground for the whole industry and at the same time allay legitimate concerns for safety and soundness.

We are confident that the result will be a stronger, more competitive financial system, one which would be more fully able to meet the challenge of foreign banks both here and abroad. But perhaps the beneficiaries who would reap most from this new system would be consumers. Consumers always benefit from a competitive marketplace. More competition results in lower prices, increased product innovation, and generally better service.

Mr. Chairman, the time is late, but we are working at the Association of Bank Holding Companies with our colleagues in other associations to reach a consensus on the legislative program which can enlist support from other segments of the financial services industry as well. We stand squarely behind your efforts to break the logjam and hope we can be helpful to you and this committee in formulating a broadly supported new program.

[The complete prepared statement follows:]

practical differences between the holding company itself and its banking, securities, insurance, or other subsidiaries, and does not place the same restrictions on the activities of the holding company as are placed on the bank subsidiary. Existing law, of course, imposes extraordinary and in our view unnecessary limitations on the nonbanking activities of bank holding companies.

We conclude, Mr. Chairman, that existing law flunks the test of sound public policy. This means new legislation is needed. I now turn to our thoughts on how to structure that legislation in light of the public policy goals set out above.

The Appropriate Legislative Response

There is always a temptation, in a situation like this one, to think that a small step will be easier to take than a large one. But we respectfully suggest, Mr. Chairman, that a modest, piecemeal approach to today's problems of financial institution structure and regulation is inadequate in light of the market-place reality -- and we must note, from our own experience, that the piecemeal approach has not met with success in the Congress over the years. We believe that the Congress should recognize that in a modern technological era customers -- both individual and institutional -- demand financial services, not simply what we used to think of as commercial banking, or thrift, or insurance, or securities services. Many firms that are free of the artificial legal constraints applicable to bank holding companies have already begun to serve the full range of financial needs of their customers.

We suggest that new legislation should permit a holding company to own subsidiaries engaged in providing a variety of financial services. Each subsidiary should be regulated based on the function it performs. For example, a holding company could own a bank, which would be regulated by the banking regulators, and a securities firm, which would be regulated by the SEC. The securities underwriting and dealing activities of the bank would be transferred to the securities subsidiary, so as to assure fair functional regulation. This structure would allow the holding company to diversify its activities, and thus its financial risks, in the way a bank or bank holding company cannot do today.

Let me emphasize that what we have in mind is very much a two-way street. We seek no special advantage for banking institutions, and would, of course, oppose perpetuating the special advantages of securities firms. New legislation, in our view, ought to permit securities firms, through their holding companies, to own full-service banks -- banks that take demand deposits and make commercial loans, and are regulated by the appropriate federal banking regulator -- and at the same time permit bank holding companies to own full-service securities firms -- firms that underwrite and deal in corporate securities in the United States subject to the regulatory authority of the

SEC. It would, of course, be entirely inconsistent with sound public policy -- though the suggestion was once made by the securities industry in apparent seriousness -- to permit securities firms to acquire full-service banks while allowing banking institutions only a limited set of new securities activities. Sensible public policy requires a level, two-way street.

We think it quite clear that allowing holding company subsidiaries to engage in banking as well as securities activities meets the public policy goals laid out above. For example:

-- Safety and soundess would be improved by providing a way for banking institutions to diversify risk. One recent study concluded, for example, that eliminating restrictions on the financial services banks can provide would have reduced the volatility of average commercial bank earnings by 15%-30% over the past 25 years. A more stable and stronger banking system would be better able to serve the needs of the American economy.

-- Economic efficiency would be improved because each holding company could, under appropriate regulation, enter portions of the financial market in which it believed it could compete successfully. Increased competition in the concentrated securities markets -- now dominated by a few broker/dealers -- would inevitably result in lower costs for corporate and municipal issuers. Increased competition would also assure the

efficient flow of credit in the economy, through the efforts of subsidiaries of holding companies as well as specialized broker/dealers, banks, finance companies and others. Fair competition would be assured by functional regulation of subsidiaries.

-- Flexibility to respond to developments in the marketplace would be enhanced by the elimination of artificial constraints on the activities of financial intermediaries. In the commercial paper market, a broker/dealer subsidiary of a holding company could serve the customer by underwriting and dealing in commercial paper, even though the bank subsidiary had lost the customer as a borrower. When new developments occur, the holding company could respond without the need for additional legislative action by Congress on a piecemeal basis.

-- The existing regulatory structure provides a way to regulate the subsidiaries of the holding company on a functional basis. New legislation would improve the ability of the regulators to carry out their jobs by allowing them to focus on examination and enforcement of the laws they administer, rather than (as is so often the case today) trying to figure out (and then litigate about) the application of old, ambiguous laws to activities conducted by an affiliate of a bank or securities firm.

There are other advantages of progressive financial institution legislation that should be mentioned, particularly the impact on our nation's international competitive position. Right now, we are allowing jobs and economic activity to move abroad, simply because affiliates of U.S. banks can underwrite and deal in securities -- including U.S. corporate debt and equity -- in foreign markets (such as the Euromarket) even though they cannot do so in the United States. In addition, financial centers such as London and Tokyo are in the midst of efforts to liberalize their financial markets, with the clear intent of capturing additional business from U.S. money centers. By modernizing our financial institution legislation, we will put the country in a position to bring that business home.

You will undoubtedly hear objections to our suggestion from those anxious to protect their privileged competitive position. Some elements of the securities industry will undoubtedly trot out the ancient canards of conflict and risk in an effort to derail progressive, sensible, modern financial institution legislation. We have dealt at length with those arguments before, and there is no need to do so again here. I will simply refer the Committee and the staff to the materials we have submitted for the record, and to the testimony of my predecessor, Morgan Stark, before this Committee in June 1985 on these exact points.

We also note in this connection the comments of William Schreyer, Chairman and CEO of Merrill Lynch, who recently said:

> "In my opinion, the Glass-Steagall Act . . . is critically ill and probably terminal . . . . Basically, banks and securities firms should have the same opportunities and the same regulations, whether it be on tax treatment or any other issue . . . . The ground rules should be identical, whatever they are, with the ultimate beneficiary being the financial consumer. The consumer would get -- through greater competition -- better products, better price, and better service."

And, in addresing the SIA Annual Convention last December, James Robinson, Chairman and CEO of American Express Company, after describing Glass-Steagall as "the regulatory version of the Maginot Line," stated:

> I think our common legislative goal should be:
>
> Number One : To eliminate outdated statutes and regulations that inhibit innovation, efficiency and competition in the industry.
>
> Two: To ensure that banking, finance, securities and insurance firms all gain an equal opportunity to serve the credit and financial needs of the marketplace.
>
> Three: To achieve expanded product and service opportunities across the industry.
>
> Four: To allow financial companies to establish separate subsidiaries to be regulated along functional lines; this would encourage diversification by intermediaries, promote fair competition and assure equality of regulation.
>
> Five: Consistent with functional regulation, holding-company supervision should be minimized, residual in nature and related to specific public-policy goals.
>
> And Six: We must rationalize our laws with those of other nations.

ASSOCIATION OF BANK HOLDING COMPANIES
730 Fifteenth Street, N.W.
Washington, D.C. 20005

Statement of John P. LaWare
Chairman
Association of Bank Holding Companies
before
Committee on Banking, Housing and Urban Affairs
United States Senate
January 22, 1987

Mr. Chairman and members of the Committee, my name is John P. LaWare, and I am chairman of Shawmut Corporation in Boston. I am appearing here today as chairman of the Association of Bank Holding Companies, which represents the leading banking organizations in our country--both money center and regional--with about 75 percent of the commercial banking assets. Accompanying me is John F. Betar, Legislative Counsel of the Association.

We are pleased to be here today to present our views on banking legislation in the 100th Congress. We are particularly happy that we have this opportunity to explain our position to the five new Committee members.

As you know, Mr. Chairman, for the past 5 years we have appeared before you to urge that the Bank Holding Company Act be amended to permit us to engage in insurance, real estate, securities and other financial services so that we can better serve the public and compete with the unregulated providers of financial services. In addition, we have strongly supported, and continue to support, the recapitalization of the FSLIC as recommended by the Administration.

Let me emphasize as strongly as possible that our wish is to be able to compete, and we encourage others to compete with us. Competition in a free market is a fundamental characteristic of American business. Experience shows the ultimate beneficiary is the American consumer. If others can provide better banking services than we can, they should be allowed to do so. Similarly, we ask only that we be allowed to compete in providing logically-related financial

services that we are confident would broaden the choices available to the consumer. What we suggest, Mr. Chairman, could be interpreted as a challenge to others in the financial services industry. It is intended as just that.

We are recommending that the laws be even-handedly applied so that we the banking industry can have the opportunity to offer its capabilities to consumers. We are perfectly willing to let the consumer be the judge.

Financial Services Holding Company

With this in mind, we began about 18 months ago to think about an alternative method to obtain our goal of providing a wider range of financial products and services. Over this period, we have evolved the concept of a Financial Services Holding Company Act, and we are now in the process of working out the formal details. We are in a position today to discuss with you the overall approach.

Financial Competitors

We believe the primary reason that our past efforts to amend the Bank Holding Company Act have not been successful is the opposition of the insurance, real estate and securities industry to our entry into their businesses. To overcome that opposition, we propose to permit our nonbank financial competitors to have an opportunity to own a full service commercial bank. Actions by our competitors in acquiring "nonbank banks" and unitary savings and loan holding companies demonstrate their desire to own a federally-insured depository institution. In exchange for authorizing the ownership of a full service bank by financial competitors, the Financial Services Holding Company Act would authorize full entry by the banking industry into the insurance, real estate and securities fields.

Basic Concept

The basic concept of the proposed Financial Services Holding Company Act is to create a corporate structure whereby **existing** corporations "financial in nature" can voluntarily join together in a common enterprise. Existing institutions and the federal and state laws that govern them would remain intact, except to the extent that amendments may be necessary to accommodate the new financial services holding company concept. Any institution "financial in nature" could continue to function as it does today without taking any action. Change would occur only if a nonbank institution chooses to own a full service bank or a bank holding company seeks full scale entry into the securities, real estate or insurance fields.

A financial services holding company ("FSHC") is a corporation, chartered under state law, owning a bank holding company and one or more other companies financial in nature. The bank holding company is the cornerstone of the FSHC, in recognition of the fact that most American banks are now affiliated with bank holding companies. The present regulatory system of the Bank Holding Company Act would continue to apply to bank holding companies with a FSHC parent. There would be appropriate amendments to insulate the insured depository from the FSHC. Such restrictions would limit the amount of dividends payable, credit extendable, and other transactions with nonbanking subsidiaries.

The provisions of sec. 23A would be extended to the FSHC and its subsidiaries. Each subsidiary would be required to fund itself, except that the FSHC could contribute to the capital of a subsidiary. Under no circumstance would insured bank deposits be used to capitalize a nonbank subsidiary or provide assistance to such a subsidiary in the form of loans or purchase of assets.

Financial in Nature

Companies "financial in nature" include, in addition to bank holding companies, savings and loan holding companies, insurance companies, investment companies, securities companies, real estate companies, finance companies, mortgage companies and other such companies as would be defined by the statute.

Certification and Regulation

The FSHC would be certified to operate by the Federal Reserve Board, and the subsidiary companies would be regulated by their present regulators--federal or state. The functional regulation approach would be applied to each subsidiary of the FSHC. For example, savings and loan holding companies would be regulated by the Federal Home Loan Bank Board; insurance companies by the state insurance commissioner; and investment companies and securities companies by the Securities and Exchange Commission.

No Change

It should be emphasized again that the thrust of this proposal is to permit the voluntary creation a new financial corporate structure while at the same time requiring no change in the operations of existing financial institutions. For example, a bank holding company could continue to offer the insurance, real estate or securities services permitted under the restrictions of the Bank Holding Company Act. Only if the bank holding company wished to engage in a full range of insurance, real estate and securities services, would it be necessary to organize a FSHC.

Consequently, there is no inconsistency in the banking industry seeking to liberalize the permissible section 4(c)(8) activities of bank holding companies, and at the same time, advocating the broader concept of the FSHC.

Mr. Chairman, we understand that in the near future you will be introducing a bill that addresses banking issues as you see them. We would appreciate having the opportunity to comment on the specific provisions of this bill.

I shall be happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. LaWare.
Mr. Olson.

STATEMENT OF MARK OLSON, PRESIDENT, AMERICAN BANKERS ASSOCIATION

Mr. OLSON. Thank you very much, Mr. Chairman.

Members of the committee, I am Mark Olson, president of the Security State Bank in Fergus Falls, MN, and president of the American Bankers Association [ABA]. The combined assets of our members comprise about 95 percent of the total assets of the commercial banking industry. While our members range in size from the smallest to the largest banks, some 85 percent have assets of less than $100 million.

I appreciate the opportunity to present the views of the ABA on the important issues raised in Mr. Proxmire's letter of invitation. We commend you, Mr. Chairman, first for the familiar weather, and also for your and the committee's early start on these important issues.

Before moving on to the specific issues, however, I wish to stress the overriding need to reevaluate the structure and regulation of the financial services industry. As we will discuss more in our written testimony, tremendous changes are taking place in the financial services market. Traditional boundaries among financial service providers are disintegrating under the relentless pressures of improving technology and changing customer demands.

LAWS IN CRITICAL NEED OF MODERNIZATION

The laws governing financial institutions are in critical need of modernization. The leadership of the six major bank trade associations met recently to discuss this serious situation. As reflected in the joint statement which is incorporated in this testimony, these associations agreed on the urgent need for action. As the joint statement indicates, banking institutions must be granted a broad range of additional products and services and the ability of unregulated companies to own and operate federally insured depository institutions must be dealt with.

As bankers, we cannot help but be deeply concerned about the situation in which it seems almost anyone can enter our business—through the nonbank bank loophole, by acquiring a thrift, or by designing an innovative and appealing bank-like product which banks cannot offer—while at the same time we wear a legal straitjacket designed decades ago which prevents us from offering the services our customers want.

As legislators, you must be concerned with the public policy implications of this situation. As discussed in more detail in our written testimony, these archaic laws are sapping the competitive capabilities of this country's banking system—a system which is basic to our economy—and inhibiting the system's ability to earn adequate profits and raise needed capital. Furthermore, consumers are being deprived of cost savings, greater convenience, and innovative products.

Mr. Chairman, the issues which are the subject of this hearing are important. The body of our statement sets forth our specific positions on the individual issues in detail. Let me briefly summarize these positions.

We strongly support the additional securities powers which you proposed for discussion. In fact, we hope you will consider adding additional products and services flexibility to the legislation.

We support your effort to close the nonbank bank loophole and to deal with the so-called nonthrift thrift loophole. However, we are concerned about the possibility of extensive grandfathering and ineffective limitations pertaining to the ownership of thrifts. An ineffective provision on nonbank banks and nonthrift thrifts, coupled with a failure to enact broad new product and service authority for banking, could result in a financial system in which commercial banking institutions are at a permanent disadvantage.

With respect to the so-called South Dakota loophole, we have previously agreed—in the context of broader legislation—to limitations on exporting permitted services outside the home State of an institution. However, we are strongly opposed to other limitations on the authority of State-chartered institutions, and it is doubtful that we could support any legislation containing such limitations.

We understand the need for recapitalization of FSLIC and believe there are strong public policy reasons to support the administration's proposals for such recapitalization. However, we strongly believe the recapitalization provisions must be combined with provisions requiring stronger requirements with respect to thrift capital and accounting standards. It would be inadvisable for the Congress to provide for the billions of dollars involved in the recapitalization without dealing with the basic regulatory structure which led to the problems in the first place.

We support our regulators in their call for special provisions to deal with emergency acquisitions. We do have a few suggestions which we believe will strengthen the regulators' proposal.

With respect to delayed funds legislation, we would like to work with the committee to develop legislation which is beneficial to consumers, but which provides sufficient flexibility to be workable in the long run.

Mr. Chairman, the issues before us today are important ones and ones with which the Congress has been grappling for several years. We understand your wish to deal with them expeditiously. We hope to work with you to craft a package which the banking industry can support. However, we would also add that such legislation should not be seen as a comprehensive, final answer to questions surrounding the legal structure applicable to financial institutions. We hope the committee will move on quickly to answer these questions. In particular, we hope the committee will consider S. 60, recently introduced by Senator Garn, which would grant broad product and service authority to banking institutions.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT

OF

MARK W. OLSON

on behalf of

THE AMERICAN BANKERS ASSOCIATION

before the

COMMITTEE ON BANKING, HOUSING,
and URBAN AFFAIRS

of the

UNITED STATES SENATE

January 22, 1987

Mr. Chairman and members of the Committee I am Mark Olson, President of Security State Bank in Fergus Falls, Minnesota, and President of the American Bankers Association. The combined assets of our members comprise about 95 percent of the total assets of the commercial banking industry. While our members range in size from the smallest to the largest banks, some 85 percent have assets of less than $100 million.

I appreciate this opportunity to present the views of the American Bankers Association on the important issues raised in Chairman Proxmire's letter of invitation. We commend you, Mr. Chairman, and the Committee for your early start in considering these important issues. Before moving on to these specific issues, however, I wish to stress the overriding need to reevaluate the structure and regulation of the financial services industry. As we will discuss more fully below, tremendous changes are taking place in the financial services market. Traditional boundaries among financial service providers are disintegrating under the relentless pressures of improving technology and changing customer demands. New products and new providers are assuming increasingly important roles in the financial markets. Commercial banks, however, are restrained by law and regulation from participating fully in this new dynamic marketplace.

We believe there is an urgent need to redraw bankings' regulatory framework to accommodate the realities of today's marketplace. The following joint statement issued recently by the six major bank trade associations echoes this need.

Joint Statement

> The six leading bank trade associations call for urgent and fundamental modernization of the laws governing financial institutions. The associations agreed that the current laws are seriously out-of-date and must be changed if this country is to have a financial system which serves consumers and promotes a strong economy. These laws severely restrict commercial banks' ability to meet the needs of their customers and to effectively compete in domestic and international markets. These laws also provide unfair advantages to nonbank financial services companies that provide banking services without equivalent regulation. The associations believe the Congress must address the ability of unregulated institutions to own insured depository institutions.
>
> An important result of current laws is that consumers of financial products are denied the new services, cost savings and greater convenience that modern banking institutions would provide. Another result is that the long-term competitiveness of banking institutions is threatened, undermining the ability to raise capital and maintain a strong banking system which is so necessary to a healthy, growing economy. The associations believe that if this country is to assure a healthy and growing economy, it is urgent that the Congress enact legislation enabling banking institutions to offer new products and services, including securities, insurance, and real estate services. The

associations agreed to form a united front to achieve these objectives. In addition to urging the Congress to act, the associations also are calling upon the Federal banking regulators to approve additional authorities for banking institutions.

In regard to consumer legislation currently being considered in Congress, the associations agree that they will work with Congress in a positive fashion to achieve workable consumer legislation. However, the associations emphasize that, in the interest of effective consumer protection and competitive equity, consumer legislation should apply equally to all elements of the financial industry.

Finally, the associations will create a joint task force to explore proposals for a new structure for the financial services industry which will maintain the integrity of the payments system, address the ability of unregulated institutions to own insured depository institutions, ensure the safety and soundness of the financial system, and provide bank customers with a broad range of new products and services.

The associations meeting today were the American Bankers Association, the Association of Bank Holding Companies, the Association of Reserve City Bankers, the Consumer Bankers Association, the Dealer Bank Association, and the Independent Bankers Association of America.

I would like to begin my discussion with a look at the market fundamentals that influence the supply of and demand for financial products and services. Understanding recent demographic, economic and technological events lends perspective on the pressures being exerted on the current body of regulation and helps us identify emerging trends that will influence the future course of the industry.

Perhaps the most profound demographic development in recent years is the tremendous increase in labor force participation. Almost 80 percent of U.S. households today are either headed by a single individual or have both adults working. Because these households have limited time in which to transact their financial business, they attach high priority to efficient and convenient provision of financial services.

Today's consumers of financial services are better educated than any previous generation. They are not intimidated by new technology and have proved to be quite willing to use automated systems for the delivery of financial services. They have also shown a willingness to embrace new bundles of services offered by nonbank financial providers when these services better suit their needs. For example, money market funds were tremendously successful in attracting consumer funds when bank deposit rates were constrained by regulatory controls. While deregulation of deposit rates has allowed banks to compete for these funds, individual

consumers hold some $200 billion in money market fund accounts.[1] Cash management type accounts, which link together a full service brokerage account, money market funds, mutual funds, and brokered deposit instruments have proved very popular, as have lines of credit tied to transactions accounts. The success of these types of accounts reflects the value consumers place on the ability to use bundles of services.

Economic volatility over the past decade has also contributed to changing the types of financial services demanded. Depositors are no longer content to put their money in a savings account and forget it. They have become sophisticated in their choice of financial instruments and recognize the need to diversify their savings so as to achieve a proper balance between risk and return. The trend toward improved financial management techniques is equally evident among business customers. Corporate cash managers have become increasingly adept at getting maximum value from idle funds.

The most revolutionary changes in the financial services environment have come from vast improvements in technology. The ability to manage and transmit information has been enhanced by exponential improvements in each succeeding generation of computers, leading to substantial reductions in information costs and transactions costs. For example, money market funds were made technically possible by computers and telephone networks that lowered the cost of handling very large numbers of small transactions. Another example is computerized mortgage networks which allow potential home buyers to shop nationwide for a mortgage best suited to their individual needs. Sometimes both the shopping and the initial phases of the application process can be done directly from the real estate broker's office.

The expansion of diversified firms--both financial and non-financial--into a broad range of financial services provides further insight into today's market. A 1985 study by the Federal Reserve Bank of Chicago examined the activities of 30 diversified firms, including 5 insurance companies, 8 diversified financials (e.g., American Express, Merrill Lynch, and Beneficial Corp.),14 industrials (e.g., General Motors and General Electric), and 3 retailers (J.C. Penney, Montgomery Ward, and Sears, Roebuck).[2] The profits from the financial services activities of these 30 diversified firms increased 19 percent between 1981 and 1983, exceeding the earnings growth of the 15 largest bank holding companies and all domestic insured commercial banks. The 30 firms reported $8 billion in earnings from financial services in 1983, more than half of the combined profits of the nation's 14,500 insured commercial banks. The 5 insurance companies accounted for the largest share of these earnings, $3.3 billion, nearly as much as the domestic earnings of the 15 largest bank holding companies.

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[1] Institutions only money market funds have additional $76 billion in assets.

[2] Christine Pavel and Harvey Rosenblum, "Banks and Nonbanks: The Horse Race Continues," Economic Perspectives, Federal Reserve Bank of Chicago, May/June 1985, pp.3-17.

These nonbank firms also increased their total finance receivables (i.e., consumer loans, commercial loans and lease financing) during the 1981-1983 period. For example, the 5 insurance companies had a commercial lending portfolio of $48.3 billion, or nearly 30 percent of the total domestic commercial lending portfolio of the 15 largest bank holding companies.

Another example is the auto loan market. In a relatively few years, the auto industry finance company subsidiaries have captured a large share of the auto loan market. Over the past 7 years, the market share of General Motors Acceptance Corporation (GMAC) alone has grown from about 13 percent to about 25 percent. By September 1986, finance companies had a higher dollar volume of auto loans outstanding than did banks.

Many of these firms also offer deposit activities to their customers through three channels: first, by purchasing or chartering nonbank banks or savings and loans that were recently given expanded powers; second, by providing deposit substitutes, such as money market funds, from which third party transfers can be made; and third, by acting as deposit brokers, selling the deposits of depository institutions to their customers.

In sum, the interplay of demographics, economics, and technology has changed both the types of products demanded and the firms which can most efficiently and conveniently provide them. But while other organizations are pioneering the financial product and service packages that customers demand, the banking industry remains constrained by product and service restrictions fashioned over 50 years ago. We are convinced that consumers of financial services and the economy as a whole will enjoy a far more efficient financial system if the market is allowed to function with more freedom from unnecessary artificial restraints on competition.

Mr. Chairman, we strongly endorse your proposals to allow commercial banks to underwrite and distribute mortgage-backed securities, municipal revenue bonds, commercial paper and mutual funds. We are convinced, however, that this represents only the first step in what should be a more comprehensive overhaul of the laws and regulations that restrict banking institutions from full participation in the financial services industry. The following discussion will present our views on the need for expanded product and service opportunities in the areas of insurance and real estate as well as securities.

The Public Policy Perspective

It is essential to the public interest to maintain a financial system capable both of facilitating a smoothly functioning economy and meeting the diverse needs of individuals, businesses and governments with a minimum expenditure of resources.

The banking industry plays an important role in our economic system. For example, banks account for 31 percent of the financial assets of all financial institutions; they provide the bulk of the payments services; they are important managers of trust and pension assets; they are major providers of financial services to our federal, state, and local governments; and they hold about 45 percent of total consumer installment credit, originate over 20 percent of residential mortgage loans, and are important suppliers of credit to commercial businesses. The recognition that banks play such a central role in our economy explains why the industry's activities have been so heavily regulated.

In the past, tradition and regulation have determined which firms supplied which products. In today's market, tradition has given way to efficiency. Outdated regulations have created a situation in which banks are severely handicapped vis-a-vis other firms supplying financial services. Perhaps the most basic evidence of the declining importance of banks is that since the early 1970s, their market share of the total financial assets held by financial institutions has plummeted nearly 20 percent.

If this situation is allowed to continue, innovative bank and bank-like products supplied by nonbank firms will increasingly be substituted for bank services. This shift away from banks toward nonbank suppliers has two very serious public policy implications. First, as the role of banking is reduced, bank regulators and the body of bank regulation designed to protect the economy will become increasingly less effective. And second, a weaker banking industry poses significant problems both for the federal deposit insurance fund and for uninsured depositors and creditors. The casualties resulting from a shrinking banking system would impose unnecessary costs on the economy both in direct loss and indirect disruptions.

Customer Benefits of Expanded Product and Service Opportunities for Banks

We believe that consumers of financial services would benefit if banks were permitted to enter new lines of business in the areas of securities, insurance and real estate. Financial service customers are a diverse group, including individuals, small business, churches, schools, large corporations, municipalities and the federal government. The specific needs of each of these customer groups differ, but they all demand--and deserve--efficient and convenient provision of financial services. The customer benefits of expanded bank participation may take the form of lower prices for goods and services; increased use of goods and services; or the development of new products and repackaging of traditional services in new ways that promote their accessibility and utility to customers.

When people think of increased competition, the first thing that usually comes to mind is lower prices. Permitting banking institutions to enter new lines of business would lead to significant reductions in price. For example, residential real estate commissions in any given community are remarkably inflexible at 5, 6, or 7 percent, depending on the locality. But this price is higher than it needs to be. Permitting banks to enter real estate brokerage might lead to price competition as large numbers of new entrants seek ways to penetrate the market. Even a small change in the average commission rate would amount to billions of dollars in savings for real estate customers.

Although cost savings from lower prices may command the greatest attention in debates over the benefits of increased competition, they are not necessarily more important than the gains from increased use of services that result from broadening the pool of competing suppliers. The increased use of services may be due to lower prices, but more convenient access to services may also lead to increased use. For example, the existing network of banks and branches offers an ideal system for the delivery of financial services. There are over 14,400 commercial banks with more than 56,000 office locations spread across the country, serving both urban and rural markets. This physical presence in local communities makes banks a convenient location for customers to conduct a variety of financial businesses.

While both lower prices and increased quantity will provide important benefits, perhaps the most significant source of customer benefits will come through innovation--the creation of new and better products and services. In nearly all aspects of our lives and work, surely the greatest advances in our standard of living have come from changes in the nature of the goods and services we use. Today's automobiles, televisions, kitchen appliances, vacation travel, and education are all vastly different from what they were only a few decades ago. In financial services, not long ago there was no such thing as a debit card, a wire transfer of funds, direct deposit, automatic debiting of regular payments, ATMs, homeowner's multi-peril policy, no-fault insurance, discount brokerage, multi-purpose credit cards with open lines of credit, computerized mortgage shopping and origination, universal life insurance, families of mutual funds that permit investors to shift strategies with a telephone call, prepayment plans for college educations, NOW accounts, futures markets for Treasury securities, interest-rate swaps, or book entry systems for transferring and holding securities.

While past experience gives endless examples of the benefits of new and improved products and delivery systems, the specific benefits of future innovations are obviously unpredictable. We do know, however, that free and fair competition creates an atmosphere which encourages innovation. Removing regulatory restrictions is an essential ingredient to bringing about such competition.

Now, Mr. Chairman, I will address the specific issues covered in your letter of invitation.

Securities Activities

First, we support giving banking institutions the authority of offer the four securities activities mentioned specifically in your letter of invitation.

Securitization

As background with respect to these securities activities, it is important to understand the trend toward securitization in our economy. As financial intermediaries, banks have traditionally collected funds through issuing deposits and loaned these funds to creditworthy borrowers. However, recent advances in information technology and reductions in transactions costs have shifted the underlying cost advantage away from this traditional form of intermediation toward direct funding in the securities markets. The process of packaging loans and using them as collateral for issuance of a security creates value for both lenders and investors by transforming illiquid assets (individual loans) into salable securities. The result is a widening of the market of potential funds suppliers and a consequent decrease in the cost of borrowing.

The trend toward securitization is quickly spreading into new areas of bank lending. For example, securities have been issued backed by auto loans; securities backed by consumer receivables have also been sold. It is expected that securities will be issued backed by commercial loans, agricultural loans, consumer loans and student loans.

In sum, the basic nature of the market for important areas of bank lending is changing. On one side, the traditional lending in which banks can participate are shrinking; on the other side, banks are precluded by law and regulation from participating in the emerging markets. In general, we believe banking institutions should be allowed to underwrite securities backed by loans of the types which banks can, and do, make and retain in their portfolios. Such underwriting by banking institutions will benefit borrowers and entail no additional risk to the banking system.

Mutual Funds/Money Market Funds

Mutual funds provide an illustration of an important growth market in which banks are barred from meaningful participation. By the end of October 1986, there were 1,298 stock, bond and income funds with total assets of almost $402.5 billion, up from $218.9 billion in October 1985.[1] Sales of stock, bond and income funds averaged almost $550 million per day during the first 10 months of 1986.[2] The number of shareholder accounts has increased by 74 percent over the past 2 years.[3] Despite this phenomenal growth, however, only 26 percent of the 85 million U.S. households own mutual fund shares.[4]

It is interesting that over (55%) of the sales (net of reinvested dividends) over the past year have gone into mutual funds with a conservative investment philosophy, that is, mutual funds that invest in government securities or municipal bonds.[1] These funds appeal to investors who have traditionally used bank deposit instruments.

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[1] Investment Company Institute, Trends in Mutual Fund Activity, March 1986.

[2] Ibid.

[3] Business Week, February 24, 1986.

[4] Ibid.

An example of the effectiveness of mutual funds in attracting consumer investments is the individual retirement account (IRA) market. In December 1982, mutual funds had only 10.5 percent of the IRA market; by April 1986, the mutual fund market share of outstanding IRA balances had increased to 19.3 percent. Mutual funds accounted for over 33 percent of the change in IRA balances during the first 4 months of 1986. While the bank share of the market is larger, the growth trend in bank market share has been flat or negative over the past few years.

Money market funds (MMFs) have also proven to be very popular with consumers. Over the past 10 years, money market fund assets have grown from $3.6 billion to over $270 billion.[2] Almost $200 billion is in consumer-type money funds which compete directly with bank deposit instruments.

Money fund assets grew rapidly during the 5 years prior to 1983, when banks were constrained by deposit rate ceilings from competing effectively for consumer deposits. During the two years immediately following the creation of money market deposit accounts (MMDAs), money market funds experienced negative growth. Over the past 3 years, however, strong MMF growth has resumed. This continued growth in money fund assets indicates that they meet important customer needs even in a deregulated environment. Surely one attractive attribute of many MMFs is that they are coupled with other investment services like brokerage accounts or families of mutual funds. This allows MMFs to be used as a parking place between investments as well as a safe short-term investment in itself. Thus while bank MMDAs can compete directly with MMFs on the basis of interest rates, the inability of banks to offer complementary products clearly limits their effectiveness.

Allowing banking institutions to sponsor and distribute mutual funds would lead to significant consumer benefits by reaching a broader market, in part by employing their extensive branch networks for distribution of mutual funds. An April 1986 survey by Market Facts, Inc. found that 34 percent of U.S. households would like to buy mutual funds from banks, up from 20 percent in 1984. Sixty five percent of these households (22% of total households) said they would not buy mutual funds from stockurokers or investment companies.[3] This is strong evidence that the customer market for mutual funds could be significantly expanded by allowing banks to sponsor and distribute mutual funds. Consumers specifically cited confidence in bank staff, convenience of buying/selling shares at a bank, and investment performance as the reasons for preferring banks as suppliers of mutual funds.

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[1] Investment Company Institute, Op.Cit.
[2] Donoghues Money Fund Report, Federal Reserve Board H-6 Release.
[3] Market Facts, Inc., Mutual Funds '86, 1986 (Unpublished data).

Bankers' knowledge of financial markets and experience in managing customers' funds would make them valuable participants in the management of mutual funds.[1] Bank participation would also bring significant expertise in local as well as national and international financial markets. Locally or regionally oriented mutual funds could be developed, adding yet another dimension to the burgeoning mutual fund market. Such funds could be important vehicles in helping local businesses gain access to financial resources that might otherwise have shifted out of their communities, leading to increased economic activity and new opportunities for innovation by small companies.

Mortgage-backed Securities

To date the greatest progress in loan securitization has been made in mortgage-backed securities. In recent years, the operation of the mortgage market has changed rapidly as more and more mortgages are "packaged" and sold in the securities markets. Mortgage-backed securities as a percent of outstanding residential mortgages have increased from about 5 percent in 1975 to almost 25 percent by the end of 1985.[2]

The mortgages are warehoused temporarily by the mortgage bankers and depository institutions that originate them, but their long-term funding is accomplished through various types of mortgage-backed securities sold to investors of all types. In many cases, securities based on mortgages are bought for investment purposes by depository institutions, but the traditional system of financing mortgages through direct intermediation by banks, savings and loans, and other direct lenders is being displaced.

Commercial banks are not permitted to underwrite and distribute privately issued mortgage-backed securities. While the current dollar volume of private issues is small relative to government issues, the private market has significant potential for rapid growth, particularly because private issuers have more flexibility to design securities tailored to meet the specific needs of each segment of the investor market.

Between January and June 1985, three underwriting firms handled over 80 percent of the volume of mortgage-backed securities issued by private entities.[3] Allowing banks to participate in underwriting and distributing privately issued mortgage-backed securities would significantly increase the number of competitors in the market, leading to lower underwriting costs and improved service. The result would be to reduce the cost and increase the availability of funds to mortgage borrowers.

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[1] Bank trust departments already provide a similar service for nearly $700 billion in employee benefit plans and trust accounts. Approximately one thousand banks operate collective investment funds to provide these accounts greater management efficiencies and enhanced investment diversification. However, banks are prohibited from extending these services to those customers who do not have a trust relationship with the bank.
[2] Federal Reserve Bulletin.
[3] First Boston Corp., Mortgage-Related Securities Guide, 1985.

The flexibility of the private market means that it can respond to a wider variety of market opportunities. For example, private issuers can extend the benefits of the secondary market to mortgage loans exceeding the statutory limit for the government agencies, multi-family housing loans, loans on cooperatives, and commercial property loans. The private market can also create packages of mortgages and mortgage-backed securities designed to appeal to a wide range of investors. For example, collateralized mortgage obligations (CMOs) split the cash flow of the underlying mortgages into several different maturities. Innovations like these will widen the market for mortgage related securities and increase the liquidity of the underlying mortgage instrument. Because banks are knowledgeable in all aspects of mortgage markets, they would be valuable contributors to this continuing innovation process.

Commercial Paper

Perhaps the most basic function of commercial banks historically has been commercial lending. However, banks have lost an important share of this traditional loan market. In 1965 commercial lending at large banks accounted for more than 85 percent of the short-term credit of domestic nonfinancial corporations. By 1975, the share was about 70 percent; and in 1984, it was less than 60 percent. Much of this market share was lost to commercial paper.

Outstanding nonfinancial commercial paper, which is a close substitute for banks' commercial and industrial (C&I) loans, increased 140 percent during 1980-1985, while banks' C&I loans grew by only 51 percent. Increasingly, medium-sized businesses are joining large corporations as issuers of commercial paper, indicating that the trend is likely to continue.

It is clear that the commercial paper market has achieved a major position in short-term business finance. The increasing substitution of commercial paper for commercial loans implies that direct loans from banks are a relatively more expensive source of funds for some borrowers. As the commercial paper market matures and becomes accessible to more borrowers, banks will face continued erosion of one of their most important loan markets.

Currently, some 85 percent of intermediary-placed commercial paper is controlled by 5 investment banking firms.[1] We believe that banking's participation in underwriting and distributing commercial paper would

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[1] Securities Industry Association vs. Board of Governors of the Federal Reserve System and Bankers Trust Co., United States Court of Appeals for the District of Columbia Circuit, Brief for Appellant Bankers Trust Co., March 10, 1986.

increase competition, leading to reduced cost and improved service for issuers.

Banking organizations have experience in making business loans and providing letters of credit that back commercial paper and other investment instruments. Banks also have considerable expertise in analyzing local business markets and evaluating the financial condition of their business customers; these skills can be readily adapted to commercial paper advisory and placement services.

Bankers' local knowledge could also help expand the market for commercial paper to those smaller companies who might benefit from the use of commercial paper, but who would otherwise be unlikely to have access to the market. Lower borrowing costs for these smaller companies may stimulate investment, leading to more jobs and increased output. Moreover, the decreased cost of borrowing will ultimately be passed through to consumers as lower prices.

Municipal Revenue Bond Underwriting

Although commercial banks are one of the major holders of municipal revenue bonds, they have very limited authority to underwrite and distribute them.[1] When the Glass-Steagall Act was passed in 1933, Congress specifically provided an exception for general obligation bonds from the broad prohibition on bank securities underwriting contained in that Act because it wanted banks to continue to underwrite municipal securities. In 1933, this exception covered virtually all state and local government issues. In 1985, however, revenue bonds accounted for some 75 percent of the dollar volume of state and local issues.[2] Thus, banks can not fully compete in underwriting the largest share of the municipal bond market despite the clear intention of Congress to have banks participate in this market. This is a prime example of the need to update decades old banking laws to meet today's market realities.

State and local governments would realize cost savings if banking organizations were allowed to underwrite and distribute a full line of municipal revenue bonds. Added competition would result in lower underwriting fees; banking's participation would add liquidity to the secondary market, thus reducing interest costs; and banking's participation would expose these issues to new investors, increasing the size of the market. Participation by banks would also increase access to the market by issuers, particularly small issuers in rural areas.

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[1] Municipal revenue bonds are debt obligations issued to finance a specific income producing project, and are to be repaid out of that stream of income. General obligation bonds are backed by the full faith, credit and taxing power of the issuer.

[2] Public Securities Association.

state chartered institutions, and it is doubtful that we could support any legislation containing such limitations.

We understand the need for recapitalization of the FSLIC and believe there are strong public policy reasons to support the Administration's proposals for such recapitalization. However, we strongly believe the the recapitalization provisions must be combined with provisions requiring stronger requirements with respect to thrift capital and accounting standards. It would be inadvisable for the Congress to provide for the billions of dollars involved in the recapitalization without dealing with the basic regulatory structure which led to the problems in the first place.

We support our regulators in their call for special provisions to deal with emergency acquisitions. We do have a few suggestions which we believe will strengthen the regulators' proposal.

With respect to delayed funds legislation, we would like to work with the Committee to develop legislation which is beneficial to consumers, but which provides sufficient flexibility to be workable in the long run.

Mr. Chairman, the issues before us today are important ones and are ones with which the Congress has been grappling for several years. We understand you wish to deal with them expeditiously. We hope to work with you to craft a package which the banking industry can support. However, we would also add that such legislation should not be seen as a comprehensive, final answer to questions surrounding the legal structure applicable to financial institutions. We hope the Committee will move on quickly to answer these questions. In particular, we hope the Committee will consider S.60, recently introduced by Senator Garn, which would grant broad product and service authority to banking institutions. I would like to publicly thank Senator Garn for introducing this legislation.

The **CHAIRMAN**. Thank you, Mr. Olson.

Mr. Olson, you say on page 15 of your testimony:

> The ABA's position is in support of closing the nonbank bank loophole with no grandfathering or at a minimum an early grandfather date.

But you express concerns that legislation on this issue may prove to be ineffective.

Can you tell us now what should be included in a loophole closure to make it effective and submit for the record legislative language to accomplish that purpose?

Mr. **OLSON**. We would be glad to submit language on that, but our concerns basically are two.

No. 1, we think that if the nonbank bank loophole were closed but a nonthrift thrift loophole were not, that basically the same avenue would be available for entry. And that, in combination with very liberal grandfathering, could make the provision ineffective. Those two are the two strongest of our concerns, but we would be happy to submit language.

The **CHAIRMAN**. Thank you, Mr. Olson. Mr. Olson, let me tell you that things don't get done around here unless there's really effective lobbying, as you know. And I hope that the the American Bankers Association will do that. You can be very effective, believe me. In 30 years on this committee, I can tell you how effective you can be. So if you really go after it, you can make a difference.

Mr. **OLSON**. We are ready to provide what help we can.

The **CHAIRMAN**. Thank you.

FINANCIAL HOLDING COMPANY PROPOSAL

Mr. LaWare, as I read your financial holding company proposal, it's a very interesting one. An existing bank holding company could get into the insurance business by forming a parent financial holding company which would own the bank holding company and an insurance company.

Now that's 180 degrees contrary to title 6 of the Garn-St Germain Act of 1982 which specifically prohibited bank holding companies from engaging in insurance.

What makes you think the Congress is ready to reverse itself so quickly?

Mr. LAWARE. Well, I'm not sure that you are and I'm sure that the insurance agents will be out in force lobbying against that.

The CHAIRMAN. You can be sure of that.

Mr. LAWARE. But it is part of the proposal here to allow financially oriented companies to be in all segments of the financial services industry without mixing banking per se with any of the others. That's why we insulate that banking subsidiary from the others.

Obviously, there is going to be still some competitive disadvantage, but there are a number of insurance companies who would like very much to be in the banking business and several of them own nonbank banks. This would give them an opportunity to own a full-fledged bank as long as they are willing to submit it to the same kind of isolation and insulation that the rest of us would do under this proposal.

The CHAIRMAN. Well, I would challenge that insulation and isolation. It seems to me that would be a fiction.

Mr. Doyle, Mr. Gould of the Treasury Department testified yesterday that he believes Congress should act immediately to recapitalize FSLIC but should leave other banking legislation until later.

You, on the other hand, state on page 1 of your testimony that the IBAA cannot support the administration's plan to recapitalize FSLIC unless it is part of a bill that would close the nonbank bank and nonthrift thrift loopholes.

I think that is a strong position and I certainly enthusiastically support it, but can you tell us why you feel so strongly that these two issues must be coupled and why you disagree so emphatically with Mr. Gould on his suggestion to decouple them?

Mr. DOYLE. Well, in the first place, we would concur with Mr. Levy—and I heard his earlier testimony here—that the whole purpose of the FSLIC recapitalization and also the regulators' bill is to provide special assistance under a crisis situation. We feel that if we are trying to get the highest value for the institutions that are troubled that we must have the closure of the nonthrift and the nonbank loopholes because people who are interested as potential acquirers of our troubled institutions are acquiring those institutions to get the franchise to that marketplace. And if they can achieve the same thing by the loophole technique and enter the market through the loophole, then they have no enticement to acquire the failed or failing thrift or bank that may be involved.

So we feel if they really want to add value and to stabilize the industry that you must have the loophole closing in concert with either the regulators' bill or with the FSLIC recapitalization.

The CHAIRMAN. Thank you very much. My time is up.

Senator Garn.

Senator GARN. Mr. Doyle, if you continue to insist on that position, let's assume it passes. Suppose we get a FSLIC recapitalization and close the nonbank bank loophole on some basis that nobody is willing to answer here today because I'm not sure they

A 1979 paper, which surveyed 12 studies by 9 different research teams, focused on the impact of greater banking participation in the revenue bond market on the costs to borrowers.[1] Based on 1977 data, this paper estimated that on a total volume of $27 billion, savings to issuers would range from $150 million to $300 million. (Based on the $162 billion of municipal revenue bonds issued in 1985, this would imply savings of $810 million to $1.6 billion).

Since small issues do not attract regional or national attention and investment banks do not have a local presence and customer contact in small localities, banking institutions are natural underwriters for small municipalities. This may help explain why small municipalities rely more heavily on general obligation bonds to meet their financing needs. In 1985, 45 percent of long-term municipal bond issues were for less than $5 million. Of that total, 63 percent were general obligation bonds. By contrast, general obligation bonds accounted for only 29 percent of the long-term issues of $5 million or more.[2] Expanding the banking industry's authority to underwrite a full line of revenue bonds will give smaller municipalities more and better financing alternatives.

Banks are often the primary financial institutions serving their state and local governments. Bank managements work with key members of these governments to help them meet their financing needs. Allowing the banking industry to underwrite a full line of municipal revenue bonds should lead to better overall service and greater innovation in structuring the types of bonds offered.

Because they recognize the potential for cost savings and improved market access, all the major organizations of state and local governments--such as the National Governors Association, National Association of Counties, National League of Cities, U.S. Conference of Mayors, and Government Finance Officers Association--have endorsed permitting banks to underwrite revenue bonds.

Summary on Securities Activities

Mr. Chairman, the evidence presented above clearly indicates that restraints on the product and service opportunities of banks are having a negative impact on the ability of the industry to serve their customers and their communities. The changes taking place in the financial services marketplace offer a great opportunity to improve the efficiency of production and delivery of financial services. Before the banking industry can become a full participant, however, Congress must act to remove the outmoded legal and regulatory restrictions that prevent banks from competing as equals in the financial services arena.

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[1] William L. Silber, "Municipal Revenue Bond Costs and Bank Underwriting: A Survey of the Evidence," mimeo., September 28, 1979.

[2] Public Securities Association, Municipal Market Developments.

The primary impact of the securities restrictions contained in the Glass-Steagall Act today is not to protect the stability of the economy or the commercial banking industry, but to inhibit competition in financial markets. Whatever the perceived merits of the Glass-Steagall Act may have been in 1933, the restrictions on commercial bank securities activities are clearly incompatible with today's financial world.

We are aware that our competitors -- many of whom already offer combinations of bank and bank-like products and securities products -- will argue that allowing banks to participate in securities activities will open a Pandora's box of problems including increased risk and potential conflicts of interest. We are convinced that these arguments have no basis in fact. Moreover, as we have demonstrated earlier in this statement, we believe that substantial public benefits will flow from increasing competition in the underwriting of municipal revenue bonds, commercial paper, mutual funds, mortgage-backed securities, and other securitized bank loans.

Perhaps the most important issue raised by our opponents is whether allowing banks to participate more fully in securities markets will expose the banking industry to a significantly greater degree of risk than it faces now. There are two components to this question: will the combination of the new activities with traditional bank activities result in an increase or a decrease in overall bank risk, and are there ways to insulate the bank from those activities which may pose an increased risk?

Current banking laws and regulations have created several inconsistencies between those securities activities which are permitted and those which are denied. For example, banks are limited in their ability to underwrite commercial paper, although they can make and hold commercial loans and can issue standby letters of credit backing commercial paper. Banks cannot underwrite most municipal revenue bonds, although as mentioned previously they can underwrite municipal general obligation bonds and housing and education oriented revenue bonds. Banks cannot sponsor and distribute mutual funds, although they can offer virtually the same product through the trust department to their trust customers. Banks can underwrite the mortgage-backed securities of federally sponsored agencies, although they cannot underwrite privately issued mortgage backed securities. And banks can make and hold a whole host of commercial, consumer and agricultural loans, but cannot underwrite and distribute securities backed by these loans. These inconsistencies cannot be justified on the riskiness of the prohibited activities. Clearly, our opponents are merely seeking to protect themselves from competition from the banking industry.

The fundamental risk in underwriting is that the principal value of the securities will decline before they can be sold by the underwriter. The risks involved in an underwriting -- in which the underwriter generally holds the security for only a few days -- are certainly no greater than the risks involved in extending a commercial loan which will be held in the bank's portfolio for several years. Banks already have the experience and expertise to assess both the financial condition of the client and the general economic environment. Moreover, banks already successfully participate in underwriting general obligation municipal bonds, Euromarket securities, and perform private placements for their clients.

Many in the securities industry also continue to charge that there is an inherent conflict of interest between banking and underwriting and dealing in securities, and therefore banks must be excluded from securities markets. This argument is becoming increasingly difficult to defend as the financial services industry continues to homogenize. Affiliations among securities firms, insurance companies, real estate firms, manufacturing firms -- and the ability of all of these to own nonbank banks -- offer the potential for exactly the same conflicts of interest. The point is that conflict of interest situations are pervasive in all aspects of life; certainly they are not unique to banking. For example, if there is a potential conflict of interest between commercial lending decisions and securities underwriting, certainly such conflicts must also exist when securities firms own nonbank banks, or when securities firms are affiliated with insurance companies or finance companies which engage in commercial lending.

Eliminating all conflicts of interest is not possible or desirable; what is necessary is to assure that we have laws and regulations to prevent misconduct stemming from such conflicts. Congress has chosen to rely on disclosure, regulation and judicial enforcement to control conflicts of interest that arise in the securities industry. We believe that this framework, in addition to existing bank regulations governing interaffiliate transactions and the system of bank supervision, will provide adequate protection.

In sum, Mr. Chairman, we would strongly support Congressional action authorizing the four securities powers which are the subject of this hearing. Indeed, we believe the Congress should in the near future go further and permit banking to offer a broader range of additional products and services, not only in the securities area, but in insurance, real estate, and other financial services as well. We hope that this Committee will take a serious look at the legislation recently introduced by Senator Garn, S.60, which would provide for this broader range of products and services.

Nonbank Banks

The nonbank bank phenomenon is another indication of the total inadequacy of the regulatory structure in the current market environment. Under existing law, a bank is not a bank under the Bank Holding Company Act (BHCA) unless it both takes demand deposits and makes commercial loans. The parent of a limited service bank that refrains from making commercial loans will not be subject to the activity limitations of the Bank Holding Company Act and will be free to acquire or charter other limited service banks throughout the country. Alternatively, another limited service bank can make all types of commercial and other loans, accept time deposits, savings accounts and NOW accounts, but escape the BHCA's definition of bank if it avoids taking demand deposits. Unbelievably both types of limited

purpose bank can even be owned by the same parent, thus offering complementary and complete banking services.

Our membership is greatly concerned with the growing number of nonbank banks; the number of FDIC-insured institutions not considered banks under the BHCA reached about 185 at mid 1986. Moreover, FSLIC-insured institutions are excluded from the definition of "bank" for purposes of the BHCA even though these institutions have been granted significantly expanded powers and are to many customers virtually indistinguishable from banks. Companies that own FSLIC-insured institutions are governed by the Savings and Loan Holding Company Act, which imposes no limits on the activities of unitary S&L holding companies.

The increase in the number of nonbank banks owned by diversified companies since 1980 indicates that the threat of legislation to ban nonbank banks has failed to diminish their appeal.

The legislative approaches taken to date raise two serious concerns. The first concern might be called "grandfather creep". From a position allowing no grandfathering of any existing institutions in some of the early proposals, the grandfather date has been constantly moved forward in time. Many observers are now predicting a 1987 grandfather date. Second is the issue of the so-called nonthrift thrift. None of the legislation considered so far would have included FSLIC-insured institutions for purposes of the BHCA. Some proposals placed limitations on the ownership and operation of federally insured thrifts by diversified firms by imposing a "qualified thrift lander test" on unitary S&L holding companies. However, the definition of qualifying investments was often sufficiently broad so as to be easily met.

The ABA's position is in support of closing the nonbank bank loophole with no grandfathering, or at minimum an early grandfather date. However, we are deeply concerned that legislation on this issue may ultimately prove to be ineffective. A large number of institutions may be permanently grandfathered, including many major corporations. Furthermore, additional institutions may be allowed to continue to enter the banking business as a practical matter by purchasing a thrift. We appreciate your willingness, Mr. Chairman, to deal with this important issue. However, we certainly hope the Congress will not pass legislation which proves to be ineffective and then assume the problem of an inadequate, out-of-date regulatory structure has been solved.

The "South Dakota Loophole" Issue

We believe the the opportunity for states to authorize new products and services for the banks they charter and supervise is inherent in our dual banking system. At the same time, federal oversight of all FDIC insured banks ensures that all commercial banks, whatever their charter, will operate in a safe and sound manner.

The dual banking system has worked quite well in providing banks with the authority needed to compete in a changing environment. For example, Massachusetts was the first to permit banks to offer NOW accounts. Today, many states are acting to permit their state chartered institutions to offer expanded products and services, including insurance, securities and real estate activities which are not permitted for national banks or bank holding companies. For example, Wisconsin recently passed a comprehensive banking law. Subject to state regulatory approval, banks chartered in Wisconsin may offer any financial product or service offered by other financial service firms, except insurance underwriting. We strongly support the right of individual states to take such actions.

Within the context of broader legislation expanding product and service authorities, we have previously stated that we would not oppose efforts designed to prevent "exporting" of state authorized activities beyond the state's boundaries. Generally, proposals to "close the South Dakota loophole" in fact go much further. They would limit the authority of state banks to offer insurance, and in some cases other services, even in the home state of the institution. We strongly oppose legislation that would nullify a state's ability to authorize expanded product and service opportunities for their state chartered banks. We believe that the viability and competitive health of the banking industry in this country depends on the continued existence of the dual banking system; it is the essence of this system that state legislatures, as well as the federal government, be able to determine the activities of the banks they charter.

On the specific issue of insurance I would ask the members of this Committee: could there be a worse time to limit competition in the insurance business? In view of the current problems regarding the cost and availability of some insurance products, we believe it is relevant to consider the customer benefits that would flow from banks' participation in underwriting and selling all types of insurance. While banking's entry into insurance underwriting would probably start slowly and focus on the most predictable risks, allowing banks into the business should make future insurance cycles smoother, thereby stabilizing the overall earnings and performance of participants.

Allowing banks to underwrite insurance would provide a badly needed increase in underwriting capacity in the property/casualty area. The need for additional capacity was amply documented more than a year ago by the property/casualty industry's own non-profit statistical organization. The Insurance Service Office's February 1985 study on "The Coming Capacity Shortage" predicted that the availability of property/casualty insurance would fall short of demand by $62 billion in the 1985-88 time frame. In this study's evaluation and recommendations section, it strongly questioned the continuation of the insurance industry's strident opposition to entry by other financial entities.

The competitive benefits of permitting banking organizations to enter insurance underwriting would improve industry efficiency, resulting in lower costs and improved service for customers. There would be an increase in underwriting capacity which should reduce the likelihood of severe market constrictions, including the outright withdrawal from certain markets by some insurers. Moreover, permitting the banking industry to

underwrite all types of insurance will encourage innovation, creating new types of insurance products designed to meet the changing needs of the market.

Insurance products have traditionally been distributed through a network of agents, brokers and company representatives. Recently insurance underwriters have begun to look for less expensive, more efficient distribution systems. For example, direct mail has become an important tool in marketing some insurance products.

In a 1983 study, Arthur Young & Company found that banks' retail branch networks are admirably situated to offer insurance more efficiently and on lower margins than many independent insurance agents.[1] By reducing distribution costs, it has been estimated that banks can save their customers about 10 percent of their annual insurance premiums. Competition from banks can be expected to force insurance brokers to find ways to lower their distribution costs as well. The increase in competition in insurance sales is very likely to result in a vastly more efficient insurance system which would benefit the consuming public and the overall economy. A conservative estimate of the potential benefits of bank participation in insurance sales places annual savings at some $8 to $10 billion.

The banking industry currently has limited authority to sell insurance services. National banks are permitted to sell insurance services in towns with 5,000 or fewer residents. Also, in December 1983, the Comptroller of the Currency ruled that national banks can rent or lease lobby space to insurance agencies.

State-chartered banks have the authority to provide more extensive insurance services than national banks in several states. In some areas (e.g., the midwest), the combination of banking and insurance brokerage is commonplace. In fact, a sizeable portion of the members of the Independent Insurance Agents of America's affiliated state organizations in the midwest are bank agents.

Bank holding companies and their nonbank subsidiaries are generally precluded from engaging in insurance brokerage activities, subject to several specific exceptions. One exception permits bank holding companies and their subsidiaries to offer credit life, health, accident, and unemployment insurance to their customers. Another exception grants bank holding companies in small towns (5,000 or less in population) authority to sell all types of insurance.

In Connecticut, Massachusetts and New York, savings banks are permitted to sell life insurance, although protectionist restrictions severely limit their ability to compete. The June 1986 Consumer Reports recommends that residents of these states consider filling as much of their insurance needs as possible with Savings Bank Life Insurance since the rates for those policies tend to be quite low.[1]

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[1] Arthur Young & Company, Assessment of Business Expansion Opportunities for Banking, (Prepared for the American Bankers Association, March 1983).

In his book The Invisible Bankers, Andrew Tobias quotes a senior executive at Equitable Life Assurance Society: "Anyone who did not first purchase all the Savings Bank Life Insurance he or she qualified for, before buying additional coverage elsewhere, was throwing money down the drain."[2]

A national survey by the Unidex Corporation indicates that consumers are interested in buying homeowners and automobile insurance as well life insurance through banks.[3] The 1984 survey asked nearly 1,800 persons 18 years and older about their insurance needs and whether they would buy these services from banks. Younger customers, those with incomes of less than $30,000 and comparatively low savings balances, were most receptive to the idea of buying insurance through a bank.

The banking industry has an extensive customer base that needs insurance products and services as a means of risk management. Banking organizations would be a valuable source of information and assistance to their customers in determining and satisfying their insurance needs. As discussed above in those areas where banking institutions (including savings banks) are now offering insurance, consumers are being offered a convenient service, often at lower cost, without the problems generally cited by opponents of bank entry into insurance.

FSLIC Recapitalization

We understand the importance of the Congress acting to bolster the financial stability of the Federal Savings and Loan Insurance Corporation. The problems associated with the insolvency of an ever growing number of savings and loan associations throughout the country and the inability of the FSLIC to effectively handle these problems has created a threat to public confidence in the entire financial community. Without recapitalization of the FSLIC in the near term, it is clear that the Federal Home Loan Bank Board will not be able to dispose of already insolvent institutions in a timely manner which will minimize the ultimate costs to the Federal government, the banking system, and the general public.

Nevertheless, we believe any legislation to recapitalize the FSLIC should require that the Federal Home Loan Bank Board strengthen the regulations governing S&L capital and accounting requirements. In developing legislation to meet the present and future financial needs of the FSLIC, one critical element must be the ability of the the Federal Home Loan Bank Board to limit the number of new insolvencies in the savings and loan industry. To effectively reduce future claims against the insurance fund, the FHLBB must establish effective supervisory controls and regulations which will ensure the operation of the industry in a safe and sound manner. Foremost among these are strong capital and accounting standards. At a minimum, the Federal Home Loan Bank Board should be directed to bring the capital and accounting requirements of the thrift industry to the levels mandated by the Federal banking regulators for commercial banks. Of course, under present circumstances, we understand the need for an appropriate phase-in period for these new requirements.

Regulators' Proposals for Emergency Acquisitions

We have previously endorsed, and we continue to support, the "regulators' bill." This bill would provide for the emergency interstate acquisition of failed or failing banks or bank holding companies with assets in excess of $250 million. It has been designed to ensure that it does not provide an end-run around state laws governing geographic location. At the same time, however, it would provide the Federal banking agencies with important additional authority to deal with closed or closing banks.

More limited authority which had been granted to the Federal banking agencies to sell failed banks across state lines expired on October 15 of last year. The regulators have argued that, in the current banking climate, they need this authority. Even though we believe this proposal could be improved, we do not disagree with that judgement. As the Committee considers this proposal, we would urge that provisions be included assuring close consultation with state regulators at every step of the interstate acquisition process by the Federal banking agencies. In addition, the bill's definition of failing bank should be narrowly drawn to assure the appropriate use of the provisions, and to guard against Federal regulators' extinguishing shareholder ownership positions in still solvent banks through the interstate sales process. With these changes, the bill deserves the Committee's support.

Funds Availability

Interest in funds availability legislation has been prompted by complaints that depository institutions limit access to funds on deposit for unfairly long periods. We are very sympathetic to the concerns that have led to the legislation proposals introduced in the last session of Congress. We are, however, concerned that the solutions proposed are not appropriate to the problem and may impose risks on the banking industry by requiring in too many cases that we assume the good faith of depositors and/or check writers often unfamiliar to us. Nevertheless the American Bankers Association intends to work with the Congress in a positive fashion to achieve a workable solution to satisfy the concerns voiced by consumer advocates and others.

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[1] Consumer Reports, June 1986, p. 379-385.

[2] Andrew Tobias, The Invisible Bankers - Everything the Insurance Industry Never Wanted You to Know, (New York: The Linden Press/Simon & Schuster, 1982), p. 240.

[3] Unidex Corporation, Financial Institution Insurance Services - Customer Appeal, August 1984.

We operate in a highly competitive marketplace comprised of some 14,500 commercial banks, 3,200 savings and loan associations, 18,000 credit unions, 400 savings banks, and an ever increasing array of other participants. Customer service and confidence in our institutions are key ingredients for success in a business built upon mutual trust.

Abuse of customers and erosion of confidence and trust are disastrous to our ability to compete in the marketplace. Although specific instances of apparent abuse of funds availability practices can be cited, by and large commercial banks are reasonable and prudent in the use of check hold practices. In the vast majority of cases, funds are available to depositors without the imposition of a hold.

Over the past several years, our Association has undertaken a concerted effort to make sure customers are aware not only of the hold policies and practices at our individual institutions, but also of alternatives to avoid the inconvenience a hold on a critical deposit may produce. We have developed model disclosure forms and policy statements for our members to use. The disclosure statement alerts customers to the situations where a hold may be placed and encourages customers to talk to a bank officer with any questions regarding the policy.

The vast majority of our members provide notice of their hold policy when the account is opened. Over sixty percent provide notice by the teller when a hold is placed. Other methods of notification in widespread use include lobby notices and the use of statement stuffers. Given the reality of the financial services marketplace today, we cannot afford to irritate or confuse our customers. The market dictates that we be aware of their concerns, inform them of policies that affect them and be flexible enough to accommodate their needs.

Apart from notification, any legislative effort to address funds availability must be undertaken keeping in mind the actual magnitude of the problem, the risks of any such proposal, and the legitimate interest of the banking industry itself in developing and implementing solutions which maintain the safety and soundness of the payments system and the trust and confidence of our customers.

The issue of availability focuses on a problem which is inherent in a system which relies on the physical movement of paper to order funds transferred from an account at one institution to an account at another institution. A check is not cash. It is an order to a bank to pay cash to the person who is the payee of the check. Until that piece of paper arrives at the bank on which it is drawn, no one is sure whether it will be honored as valid or returned unpaid for any of a variety of reasons. Given the volume of checks processed on a daily basis in this country (over 100 million), there is no positive notice given that a check has been paid. The only notice the bank of first deposit has that a check is bad is when it is returned unpaid. It is this uncertainty which leads banks to place selective holds on deposited funds.

There are, of course, ways to transfer funds very quickly. The development over the past several years of electronic banking and the automated clearing house for the rapid clearing of electronic payments has given banking a broad new ability to effect very rapid and positive transfers of funds. Currently, over a billion transactions are processed annually through automated clearing hoses. In addition, approximately four billion transactions are completed at automatic teller machines. The key advantage to electronic banking is that it is so fast and is not subject to the delayed availability problem.

Over the years, the consumer has typically used the check as a means to obtain cash or as a medium of payment for goods and services. Anyone who has attempted to negotiate a personal check for goods or services is aware of the identification procedures that most merchants require to accept a check. These procedures exist because significant numbers of checks are returned unpaid.

The banking industry, recognizing some of the inherent limitations of the paper-based check system, has, with the advent of electronic technology, moved toward alternatives which will offer convenience never attainable with a check.

There are currently over 70,000 automatic teller machines in operation in this country. In the past few years, numerous regional and national systems have developed which electronically link these machines. These shared systems allow the consumer to use his own bank ATM card to get cash from any of a number of machines owned by various financial institutions throughout the region, state, or nation. These systems allow ready access to cash to avoid the hassle attendant to presenting a check for payment.

Similarly, there has been a move to point-of-sale terminals in retail establishments. These terminals use the customer's ATM card to transfer instantly the amount of the purchase from the customer's bank account to that of the merchant without any cash ever changing hands. In each of these cases, the validity of the card, user, and the account balance can be verified electronically and the transfer effected immediately, thus eliminating the delay and uncertainty of a check.

Any discussion of funds availability must consider the realities of the check processing system, the fact that some checks are indeed returned unpaid, and the risks associated with making funds available without knowing whether or not the checks will be paid.

The check payment system relies on the physical movement of paper to order funds transferred from an account in one institution to an account in another. In order to accommodate this paper movement, a complicated system involving correspondent banks, the Federal Reserve, and check clearing houses has developed. A check may have to pass through several institutions and over thousands of miles before finally reaching the bank on which it is drawn. This forward passage, although it may involve numerous steps, is relatively efficient due to automation and magnetic encryption of checks. The return process, however, takes much longer. If the check is dishonored by the payor bank, the check must retrace its steps through the chain until it reaches the bank of first deposit. The return trip is not assisted by automation; it requires that each participating institution review the check manually to credit and debit accounts appropriately and to decipher from the puzzle of endorsement stamps on the back of the check the next institution in the chain before sending it back to that institution.

The return process is further delayed by the "midnight deadline" rule. Article 4 of the Uniform Commercial Code (UCC) governs check collections in each of the 50 states. The UCC requires that when a bank dishonors a check, it must return the check to the bank in the chain which originally sent it to the dishonoring bank, by midnight of the day after the dishonoring bank received it. Each intermediary bank in the chain has the same midnight deadline to send the dishonored check back to the bank from which it received it. The surest and safest way to "send" the check and assure compliance with the law is to put the dishonured check in the mail. The law deems the check "sent" if it is in the mail and out of the control of the dishonoring bank. Sending the check in the mail to each intermediary bank in the chain obviously takes considerable time.

Although the time required to process a check drawn on good funds is comparatively brief, the time to process a dishonored check is unfortunately lengthy. A bank does not receive affirmative notice that a check is "good"; if the check is not returned after a period long enough to accommodate the return check process, the bank assumes that the check was paid. Therefore, a bank with a reasonable basis for imposing a hold must delay access to the funds until sufficient time has passed to allow the check to be returned if dishonored. A hold that is one day too short is of no value.

Generally, our opposition to earlier efforts in funds availability legislation has been based on our objection to a Draconian approach which ignored the realities of the check processing system and failed to address adequately the risks involved in eliminating a bank's ability to hold checks selectively. Some legislative approaches have mandated specific funds availability schedules that had little relationship to the realities of the check processing system. These approaches imposed unfair levels of risk on banks, and ultimately additional costs on our customers.

Mr Chairman, we are willing to work with you, Senator Dodd, Chairman of the Consumer Affairs Subcommittee, and the members of this Committee to develop legislation which will alleviate the problems caused by check holds. However, the legislative solution needs to recognize the limitations of the check processing system, avoid undue risks, and provide sufficient flexibility to adjust to new developments in the use of the payments system. We also believe that any workable legislative solution should apply to all financial service providers, including securities firms, which offer check or check-like products.

Conclusion

The laws governing financial institutions are in critical need of modernization. The leaderships of the six major bank trade associations met recently to discuss this serious situation. As reflected in the joint statement which is incorporated in this testimony, these associations

agreed on the urgent need for action. As the joint statement indicates, banking institutions must be granted a broad range of additional products and services and the ability of unregulated companies to own and operate federally insured depository institutions must be dealt with.

Current laws have little to do with marketplace realities. Day after day the newspapers carry stories which make a mockery of the rationale for laws enacted years ago. Let me cite just one recent example. While commercial banks continue to be strictly limited in the services they can offer their customers, Ford Motor Company, the capitalization of which dwarfs even the largest bank holding companies, is quickly moving to place federally insured depository institutions in a nationwide network of K-Mart stores. Similarly, there is an excellent possibility that General Motors will in a few short years be the biggest player not only in the auto lending market, but in the mortgage market as well. We could cite example after example which demonstrate problems with our regulatory structure which would be absurd were they not so serious.

As bankers, we cannot help but be deeply concerned about a situation in which it seems almost anyone can enter our business -- through the nonbank bank loophole, by acquiring a thrift, or by designing an innovative and appealing bank-like product which banks cannot offer -- while at the same time we wear a legal straitjacket designed decades ago which prevents us from offering the services our customers want.

As legislators, you must be concerned with the public policy implications of this situation. As discussed in more detail in this testimony, these archaic laws are sapping the competitive capabilities of this country's banking system - a system which is basic to our economy - and inhibiting the system's ability to earn adequate profits and raise needed capital. Furthermore, consumers are being deprived of cost savings, greater convenience, and innovative products.

Mr. Chairman, the issues which are the subject of this hearing are important. The body of this statement sets forth our specific positions on the individual issues in detail. Let me briefly summarize these positions.

We strongly support the additional securities powers which you proposed for discussion. In fact, we hope you will consider adding additional products and services flexibility to the legislation.

We support your effort to close the nonbank bank loophole and to deal with the so-called nonthrift thrift loophole. However, we are concerned about the possibility of extensive grandfathering and ineffective limitations pertaining to the ownership of thrifts. An ineffective provision on nonbank banks and nonthrift thrifts, coupled with a failure to enact broad new product and service authority for banking, could result in a financial in which commercial banking institutions are at a permanent disadvantage.

With respect to the so-called South Dakota loophole, we have previously agreed (in the context of broader legislation) to limitations on "exporting" permitted services outside the home state of an institution. However, we are strongly opposed to other limitations on the authority of have the answer of how to do that. I don't think I do any more. I've given up on that formula.

Then where do we go from there? What do you think happens in the light of a close look at the last 10 or 12 years, Garn-St Germain only passed because of a crisis. Let's be blunt about it. I'm surprised we weren't able to do something else even with other crises which have been as significantly bad over the last couple of years. Suppose we do that. Where are we then in the marketplace?

OK, we passed a regulators' bill. We passed a bailout. We closed the nonbank bank loophole. Then where do you see us going legislatively in responding to the marketplace?

Mr. DOYLE. In the first place, I think that your statement when your were chairman which you made with Chairman St Germain when we first got into this loophole closing effort warned all of those who acquired nonbank banks that June 30, 1983 was the cutoff date——

Senator GARN. St Germain's date was June 30; mine was July 1.

Mr. DOYLE. OK. But in both cases we have the problem that you keep referring to, that there are people under the wire. And, of course, we had that when the original Bank Holding Company Act was enacted. We had people under the wire. We are always going to have that when we pass any legislation such as that that is being addressed here now. And I think this country has a record of working its way through whatever loophole may have existed at the time the new law went into effect.

Senator GARN. But you're missing my point. I understand all of that. Whatever date you pick, some in, some out, all of that. Whatever that formula is or however it works, I'm assuming that we have done what you're advocating—FSLIC recapitalization, regulators' bill, nonbank bank loophole closure on some basis.

Then what do you think the prospect is for further legislation?

Mr. DOYLE. I think it's good because——

Senator GARN. In light of the past few years, you think it is good?

Mr. DOYLE. Absolutely.

Senator GARN. If you have pulled the teeth that the dentist is going to work on what happens to the rest of the mouth?

Mr. DOYLE. Absolutely. I think that the dual banking system, with or without Federal legislation, has produced innovation and new legislation on the State level that has allowed competitive action to take place within the dynamics of the dual banking system. And I think that that will go on regardless of what happens.

PLUGGING LOOPHOLES IS NO REAL ANSWER

But there's one important feature here. It's going on now because there's no national policy to keep it from going on and it's going on unfairly because people are using those loopholes to their distinct advantage over the system and the policies you have adopted. They are going around them. That's why we're calling them loopholes. You have to stop that loophole activity to gain parity with all of these folks who are trying to get into the banking business through the back door and destroy the policies that are in place now.

Now they are changing the policies through those loopholes without you having a voice in it.

Senator GARN. That's right and the courts are changing the policy and the State legislatures are changing the policy and I would be willing to bet you, Mr. Doyle, that if we did that you and I will be sitting here across this table 4 or 6 years from now saying, "When are we going to have some comprehensive banking legislation?"

In light of what has taken place, with all the push, and how hard I tried to get some of these things, the marketplace has changed much more rapidly, and as long as we deal with legislation by loophole—you plug this one and there will be a new one 2 weeks after you plug it, and we won't do anything. I have never felt more strongly about anything in my life. I don't know whether Texans bet, but, boy, I'd be willing to bet you that we're going to be sitting here—the frustration, utter frustration—you realize that before Bill Proxmire was even chairman that we had municipal revenue bonds pass the Senate and never approved by the House. Most of these are not new issues. We are dealing with issues that should have been solved 10, 12, or 15 years ago, while new ones are coming along so rapidly I'm absolutely amazed that in the last 20 years—it used to be that most of the big banks in this world were American. I don't know if you're aware of it or not, but 9 out of 10 are Japanese now and the biggest United States bank is number 8. There's only one. We're still arguing about these domestic, civil war problems while the rest of the world is going to take us over—London, Tokyo and so on—we are so behind the power curve, and yet I'm sorry— you and I have had many conversations, don't misunderstand me. We're all friends. But we're missing the boat. And I sit here listening once again to the same old testimony that's been going for the last decade—let's close this loophole and it will make things better while we do something else.

Well, my time is up, but I hope I'm wrong in my predictions, but by the next time I get to be chairman again I hope we're not starting over with the same testimony, listening to the same things while we're all learning to speak Japanese. [Laughter.]

The CHAIRMAN. Senator Graham.

Senator GRAHAM. I was interested in all of the presentations. I was particularly struck by Mr. Kelleher's comments relative to the internationalization of this issue.

It seems to me as if we are facing a merger of two different histories and philosophies of banking—the European largely transferred to Japan tradition and the United States tradition, one of which has emphasized concentration and diversity of activities; the other has emphasized decentralization and a segregation of activities, if that's not too much of an overstatement of those traditions.

INTERNATIONALIZATION OF BANKING

How do you see over the next couple of decades, as our economy becomes more integrated with the world, what are the implications of that to the financial community and what should we be doing about it today in order to prepare for that increasing integration?

Mr. **Kelleher**. Senator, I'm not sure that my crystal ball can quite extend to the 10- or 20-year period that you suggest. Perhaps just bringing it back to the present, in the matters that are of significant interest to the association that I represent here, securities matters facing commercial banks here in the United States. Clearly at the present time the breadth and the depth and the flexibility of markets overseas, both in the Far East and also in Europe, allows the U.S. domestic corporations—in fact, encourages U.S. domestic corporations to bypass the U.S. commercial banking system and to move overseas in order to satisfy their credit needs in whatever form that might take.

The globalization or the internationalization of capital markets activities has a significant impact on the commercial banking system here in the United States today, not to speak of what might be happening 10 or 20 years down the road.

And in terms of dealing with that particular issue, our association believes it's appropriate to consider legislation which allows for the commercial banking system here in the United States to have a securities subsidiary as part of a financial holding company, allowing full securities activities in an effort to compete here in the United States and to allow us to serve the public purpose both for individual and corporate issuance of debt and equity, I might add.

Senator **Graham**. I'd like to ask a question of anyone who wishes to respond. Mr. Olson was commenting about the need to link some reforms with the FSLIC recapitalization so that we don't just provide an aspirin but leave the basic problems in place.

Earlier today some commentators stated that they did not feel any statutory changes were necessary, that sufficient administrative actions were being taken to deal with the underlying problems of the S&L industry and if we could provide this emergency relief we could have some assurance that we wouldn't be back 5 years from now where we are today.

You apparently don't share that degree of confidence. I wonder if other members could comment as to what, if anything, from a statutory standpoint beyond the nonbank bank question we should link to FSLIC recapitalization.

Mr. **Olson**. Let me speak specifically to the FSLIC recapitalization and if I can, go back and refer to your question, which was very appropriate, in which you asked the two gentlemen from the thrift industry for their analysis of the circumstance that caused that problem. And I concur with their analysis of the problem. In no way am I in conflict with it.

DISPARITY IN THE REGULATORY PROCESS

It was the resolution of the problem where we as bankers I think see a disparity in the regulatory process. For example, when all of us that had longer term assets than liabilities got caught in that interest squeeze, there was a potential option for us to get out of it; by growing out of it; and to grow out of it we could have attracted higher rate deposits by paying higher interest rates and go out and look for more risky but higher yielding loans, thereby correcting the interest squeeze and getting healthy.

I'm not an expert on the thrift industry, but by observation and by general reporting, a number of thrifts chose that vehicle. That couldn't have happened in the banking industry. A banker could not have gotten away with that to the same extent for two reasons. No. 1, our capital standards are much more strictly enforced and are much tougher than the thrift industry and we could not have expanded that rapidly without additional capital.

Second, the nature of our regulatory authority is such that our loans would have been more tightly scrutinized and we would have quickly been operating under a cease and desist or a memorandum of understanding had we tried to do that.

So the point that I'm making is that if the Congress is going to put that kind of money or allow that kind of money to go into the thrift industry, then there ought to be some parity on regulatory standards and capital standards.

Now we recognize that that would have to be phased in over a period of time, but in order for there not to be a repeat of the problem there has to be tighter regulation and consistent regulation.

The **CHAIRMAN**. Senator Graham, if you want to follow up on that, go right ahead.

Senator **GRAHAM**. I just wondered if any of the other members of the panel would like to comment on the question.

Mr. **RICE**. Well, just one thing that I think was not emphasized this morning, although the representative from the savings industry made reference to it, and this would add more logic for tying the nonbank bank loophole and FSLIC recapitalization together—is that the entry fee is less or nonexistent if you can go to an area where you could not go otherwise with a nonbank bank instead of having to acquire a failed thrift. Most nonbank banks, while they can either make commercial loans and not take deposits or take deposits and not make commercial loans choose to take deposits.

Now since they can't make loans, by definition, then they put nothing back into the community. They are only taking deposits from the community. Those deposits would otherwise be available for a full service institution, be it a thrift or a bank, to be reemployed in the community and, if properly managed, on a profitable basis.

PURSUE FURTHER DEREGULATION

The **CHAIRMAN**. Let me just say before we conclude that passage of a limited bill does not mean the committee will not pursue deregulation further. We certainly will. I will hold hearings on further deregulation, including review of the Glass-Steagall Act, review of other financial services appropriate for bank holding companies, but we must take a first step and take it promptly.

It's been a tragedy to all of us that in the last few years when there have been such enormous changes in banking and related financial services we've done nothing. So we are determined to act, and although the bill may be limited and be disappointing to some people in the banking community, I want you to know that we won't stop there. We intend to press and by pressing on I mean acting again this year. We hope we can act, however, early in the spring or before that. We will have a bill on the floor of the Senate in February—and I say "we"—I mean the House and the Senate can get together in a conference and make sure we have a bill on the president's desk early in the spring. Then we want to follow up with this other legislation.

Well, I want to thank you gentlemen very, very much. I think you have been an excellent panel.

Tomorrow we will convene at 10 o'clock to hear representatives of the consumers, of nonbank banks, and of the securities industry at ten o'clock.

[Whereupon, at 12:30 p.m., the hearing was recessed, to be reconvened at 10 a.m., Friday, January 23, 1987.]

STRENGTHENING THE SAFETY AND SOUNDNESS OF THE FINANCIAL SERVICES INDUSTRY

FRIDAY, JANUARY 23, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Sarbanes, Dixon, Graham, Heinz, Hecht, and Chafee.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

This is the last of 3 days of hearings on major banking issues confronting the Congress. I want to reemphasize the urgency of acting on these issues, including closing the nonbank bank loophole and granting new securities powers.

The nonbank bank issue is fundamental to the future of this Nation's financial system. If we do nothing, we abdicate our authority and responsibility to help shape the future of that system. Closing the loophole is also important to the success of the FSLIC recapitalization. The Chairman of the Federal Home Loan Bank Board told us on Wednesday that "it is important to the health of the FSLIC to enact legislation to close the nonbank bank loophole, once and for all." A leading S&L trade association testified that "any plan to recapitalize the FSLIC may well fall short of its potential unless the nonbank bank loophole is immediately and permanently closed." Mr. Seidman, the Chairman of the FDIC also admitted that failing to close the nonbank bank loophole will make it more expensive for FSLIC to do its job. Such testimony has strengthened my own conviction that the two issues must be coupled.

I strongly believe that the decision on whether to give banks additional securities powers should be made by the Congress and not by the regulators, and that it should be made soon. Chairman Volcker, in urging us to approve new limited securities powers, testified that the Federal Reserve Board will have to act soon on several bank holding companies' applications to engage in various kinds of securities underwriting that I think banks should have. These are: one, commercial paper; two, municipal revenue bonds; three, mortgage-backed securities, and four, mutual funds.

However, it has long been thought that the securities powers in question are not authorized by the Glass-Steagall Act. The Senate's action in 1984 in specifically granting such powers is evidence of the fact that we believe such powers are not authorized under present law. The applicants contend, however, that the act allows them to underwrite such securities as long as they do so through a company that is principally engaged in some other activity. If that theory is accepted, the once formidable Glass-Steagall Act will become a toothless tiger.

In my view, such fundamental changes in congressional policy should be made by the Congress, and not by administrative fiat. And that is so regardless of how desirable it may be for bank holding companies to conduct the activities in question.

The logical, straightforward approach is for the Congress to grant the new powers subject to appropriate safeguards. Chairman Volcker declared:

> It is simply crazy to let this process proceed through interpretations of present outmoded law and by a variety of different regulatory decisions and State actions which may be inconsistent with themselves.

I agree. The regulators should not act, but the Congress should. That is why I will ask our committee to make some very important decisions on these pressing banking issues later next month, so that we can take the bill up on the floor of the Senate just as soon as possible.

Before we start, Senators Dixon and D'Amato have statements to be inserted in the record. Without any objections, it is so ordered.

[The statements follow:]

JANUARY 23, 1987

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE

OVERSIGHT HEARINGS
ON
BANKING LEGISLATION

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE BANKING COMMITTEE CONDUCTS ITS THIRD DAY OF OVERSIGHT HEARINGS ON BANKING ISSUES THAT HAVE CARRIED OVER FROM THE 99TH CONGRESS. WE HAVE A DISTINGUISHED GROUP OF WITNESSES BEFORE THE COMMITTEE TODAY REPRESENTING CONSUMER GROUPS, THE SECURITIES INDUSTRY, THE AMERICAN FINANCIAL SERVICES ASSOCIATION, AND THE CONSUMER BANKERS ASSOCIATION.

AS I STATED AT WEDNESDAY'S AND THURSDAY'S HEARINGS, I BELIEVE THAT ACTION BY THIS COMMITTEE ON THE ALL THE ISSUES WE FAILED TO

RESOLVE IN THE LAST CONGRESS IS LONG OVERDUE. WE MUST ACT ON FSLIC RECAPITALIZATION, ON THE ISSUES ADDRESSED BY THE SO-CALLED "REGULATORS" BILL, ON THE NONBANK BANK AND SOUTH DAKOTA LOOPHOLE QUESTIONS, AND ON EXPANSION OF BANK ASSET POWERS. IT WOULD ALSO BE DESIRABLE TO REACH AN EARLY CONSENSUS ON THE CHECK-HOLD ISSUE.

I LOOK FORWARD TO HEARING FROM TODAY'S WITNESSES, AND TO WORKING WITH THEM AND ALL INTERESTED PARTIES IN CRAFTING A BILL OR SERIES OF BILLS THAT WILL ENABLE THE BANKING COMMITTEE TO MEET ITS RESPONSIBILITIES AND WHICH WILL RESOLVE SOME OF THE ISSUES THAT WERE NOT RESOLVED IN THE LAST FOUR YEARS. WE NEED TO PUT THE STRATEGY OF DELAY BEHIND US. LET THERE BE NO DOUBT. I INTEND TO DO EVERYTHING I CAN TO SEE THAT THE COMMITTEE TAKES ACTION ON THE ENTIRE AGENDA THAT IS THE SUBJECT OF THESE HEARINGS AS EARLY AS REASONABLY POSSIBLE.

Alfonse M. D'Amato

STATEMENT OF SENATOR ALFONSE M. D'AMATO
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
JANUARY 23, 1987

IN THE THIRD AND LAST OF THIS SERIES OF HEARINGS, WE WILL CONCENTRATE ON SEVERAL ISSUES THAT ARE OF GREAT INTEREST TO ME. FIRST, I AM GLAD TO WELCOME THE MEMBERS OF OUR FIRST PANEL WHO HAD TO BRAVE THE ELEMENTS TO DELIVER THEIR STATEMENTS. I BELIEVE THEIR TESTIMONY SHOULD CONVINCE EVERY MEMBER OF THE COMMITTEE THAT BANKING INSTITUTIONS HAVE BEEN DRAGGING THEIR FEET WITH REGARD TO EXPEDITING THE CHECK CLEARING PROCESS. THE EVIDENCE PROVIDED IN THEIR TESTIMONY SUPPORTS THE NEED FOR A MODERATE LEGISLATIVE RESPONSE IN THIS AREA AND THAT IS WHY I HAVE AGAIN CO-SPONSORED LEGISLATION INTRODUCED BY MY COLLEAGUE SENATOR DODD WHICH ADDRESSES THE ISSUE OF FUNDS AVAILABILITY. AS IN THE PAST, I LOOK FORWARD TO WORKING WITH SENATOR DODD TO ENSURE THE SWIFT ENACTMENT OF THIS BILL.

THE REMAINDER OF TODAY'S HEARING WILL ADDRESS ISSUES AT THE HEART OF THE DEBATE BEFORE THIS COMMITTEE - WHETHER AND HOW OUR FINANCIAL SERVICES INDUSTRY SHOULD BE RESTRUCTURED. FOR THE LAST TWO DAYS, EVERY WITNESS APPEARING BEFORE THE COMMITTEE (WITH THE NOTABLE EXCEPTION OF UNDERSECRETARY GOULD AND COMPTROLLER CLARKE) HAVE URGED US TO LET BANKS EXPAND INTO AREAS OF SECURITIES AND INSURANCE UNDERWRITING WHILE SIMULTANEOUSLY ENACTING LEGISLATION THAT CONSTITUTES AN ABSOLUTE PROHIBITION ON THE ABILITY OF OTHER FINANCIAL SERVICE ENTITIES TO ENTER INTO COMMERCIAL BANKING. THIS MORNING I EXPECT TO HEAR THE OTHER SIDE OF THIS ARGUMENT.

I BELIEVE THAT, TO DATE, THE GLASS-STEAGALL ACT HAS SERVED THE PURPOSES CONTEMPLATED BY ITS AUTHORS. IF, AS SOME HAVE ARGUED, THE GLASS-STEAGALL ACT HAS BECOME OUTMODED, THEN IT SHOULD BE MOBIFIED. HOWEVER, I HAVE YET TO HEAR ONE WITNESS MAKE A CONVINCING CASE THAT THE

CONCERNS WHICH ORIGINALLY LED TO THE PASSAGE OF THE GLASS-STEAGALL ACT ARE NO LONGER VALID CONCERNS TODAY. BEFORE WE ACT TO MODIFY OR REPEAL A PORTION OF A LEGISLATIVE STRUCTURE THAT HAS FOSTERED THE GROWTH OF THE LARGEST, SAFEST, SOUNDEST AND MOST LIQUID CAPITAL MARKET THE WORLD HAS EVER KNOWN, WE MUST SERIOUSLY EXAMINE THE LONG-TERM EFFECTS OF SUCH ACTION ON OUR FINANCIAL MARKETS. THE ONLY RATIONAL APPROACH TO THE RESOLUTION OF THE BANK POWERS ISSUE BEFORE THE COMMITTEE MUST INCLUDE A CAREFUL EXAMINATION OF THE BANK SUPERVISORY AGENCIES AND THEIR CAPACITY TO HANDLE THE OVERSIGHT OF ANY NEW POWERS. WE HAVE HEARD THE REGULATORS STATE THAT SUCH POWERS WOULD BE APPROPRIATE ONLY IF ACCOMPANIED BY APPROPRIATE REGULATORY REFORM. HOWEVER, THESE REGULATORS HAVE FAILED TO PROVIDE US WITH THE SPECIFIC REFORMS TO WHICH THEY REFER. I DOUBT THAT CONSUMERS WOULD WANT TO SACRIFICE THE STABILITY OF OUR FINANCIAL SYSTEM FOR A MARGINAL INCREASE IN THE EFFICIENCY OR CONVENIENCE IN THE RECEIPT OF FINANCIAL SERVICES.

FINALLY, I FIRMLY BELIEVE THAT CONGRESS, NOT THE FEDERAL REGULATORS SHOULD MAKE DECISIONS CONCERNING THE STRUCTURE OF OUR FINANCIAL SYSTEM. THEREFORE, I HARBOR A GREAT DEAL OF CONCERN ABOUT THE EFFECT OF THE FED'S APPROVAL OF THE APPLICATIONS PENDING BEFORE IT DURING THE COMMITTEE'S DELIBERATIONS ON THIS ISSUE. WE HAVE ALL SEEN HOW HARD IT IS TO CLOSE THE NON-BANK BANK LOOPHOLE ONCE OPENED BY THE REGULATORS. IT MAY PROVE EVEN HARDER TO CLOSE YET ANOTHER LOOPHOLE ONCE CREATED. WE CANNOT SIT IDLY AND WATCH THESE REGULATORS, WHO ARE CHARGED WITH THE AUTHORITY TO IMPLEMENT THE LAW, CHANGE THE MEANING OR TOTALLY EVISCERATE THE LEGISLATIVE INTENT OF THE LAW THROUGH NOVEL INTERPRETATIONS AND APPLICATIONS. THE PIECEMEAL APPROACH TO PROVIDING

A STATUTORY FRAMEWORK THROUGH REGULATORY FIAT WILL NOT RESULT IN A SATISFACTORY RESOLUTION OF THE POWERS ISSUE FOR ANYONE. THEREFORE, AT SOME POINT CONGRESS MUST EITHER ACT TO REASSERT ITS AUTHORITY IN THIS AREA OR PERMIT THE CONTINUED USURPATION OF ITS AUTHORITY AND THE NEGATIVE CONSEQUENCES OF SUCH INDECISION.

I LOOK FORWARD TO THE TESTIMONY OF THE WITNESSES AND THANK THE CHAIRMAN FOR PERMITTING THE VIEWS OF ALL INTERESTED PARTIES TO BE EXPRESSED IN THESE HEARINGS.

Senator **Proximire**. This morning the witnesses leading off are Alan Fox, legislative representative, Consumers Federation of America; Ms. Michelle Meier, legislative counsel, Consumers Union; and Ms. Franci Livingston, staff attorney, Congress Watch.

We are delighted to have you witnesses here. We take pride on this committee in having done at least something very helpful in the past for consumers. The truth-in-lending bill is one example and there are a number of others. This has been a great concern of the Chairman and of other Members of the committee and it is going to continue to be.

I am delighted to have you in here fighting for better representation for the American consumers and better opportunity for them to deal in what is a complicated and difficult credit market but one that is essential, of course, for consumers as well as for our economy as a whole.

Ladies before gentlemen, so, Ms. Meier, why don't you lead off and go from right to left.

Ms. **Meier**. Senator Proxmire, we have been working together.

The **Chairman**. All right. Well, you tell me how you want to go.

Ms. **Meier**. Alan Fox first.

The **Chairman**. All right. Mr. Fox, I was going to start with you but I figured ladies first. I'm old fashioned and old as well, so go ahead.

STATEMENT OF ALAN FOX, LEGISLATIVE REPRESENTATIVE, CONSUMERS FEDERATION OF AMERICA

Mr. **Fox**. In an effort to avoid unnecessary repetition, we have divided up the oral portion of the testimony and so I will lead off.

The **Chairman**. I didn't realize you were coming in as a team because you represent different groups, but the same fundamental viewpoint. Go right ahead.

Mr. **Fox**. We found that working as a team has made us more effective in the past couple Congresses.

Mr. Chairman, we are also delighted to have you in the chair and continuing your fight for consumers. You have been a longstanding champion of consumer rights and we look forward to working with you in the coming Congress on issues of concern to American consumers.

The **Chairman**. Thank you, Mr. Fox. You've made a very good start.

Mr. **Fox**. We are going to spend most of our time looking at the one issue of the five in the hearing notice that's nearest and dearest to our hearts, and that's the question of funds availability.

FUNDS AVAILABILITY PROBLEM

I don't have to tell you that the funds availability problem has been around and has been before this Congress for some time. The information we see indicates the Members of Congress have been urging the Federal Reserve Board to take action to improve availability of deposited funds for at least 10 years. There have been hearings in each of the last three Congresses. There have been promises made to consumers. There have been studies by the regulators and the industry, pilot projects. The Bank Administration Institute proposed clearing system improvements in 1975. Those improvements haven't been implemented. ANSI made a proposal for improved standards in 1981. Those ANSI standards haven't been implemented.

What all of these proposals have in common is that they rely on improvements in the return system to eventually trickle down to consumers. But return system improvements have not been implemented by the industry and by the regulators because they are not cost effective and we want to stress that improved availability of funds to consumers need not wait for return system improvements. Those are entirely separate issues.

In fact, the only effective action that has occurred on funds availability in the past few years has occurred at the State level. There are now eight States, including Wisconsin, which have passed limits on the length of time banks may hold deposited checks and we will have some comments later on the effectiveness of those laws.

For most consumers, the problem today is just as bad as it was when Congress first started looking at it 10 or more years ago. In fact, it may be worse. According to the Federal Reserve Board's survey of deposit account holders, a higher proportion of consumers reported problems with delayed funds in 1985 than 2 years earlier in 1983.

Despite what you will hear from the banking industry and from the regulators, every independent study of depository institutions' check hold policies with respect to consumer accounts indicate that unreasonably long hold periods are pervasive throughout the country.

The two most comprehensive studies were conducted by another organization we work with, the United States Public Interest Research Group, one in 1985 of 669 banks and thrifts across the country; the other in 1986 of 458 banks and thrifts. Those two surveys show the same thing. Two-thirds of all institutions hold local checks for 3 or more days. Three out of four hold out-of-State checks for 6 or more days, sometimes as long as 15 or 20 days—and those are business days. A 20-business-day hold is a month. And one-third of the institutions even hold cashier's checks issued by local depository institutions for 3 or more days and 17 percent, about one out of six, hold Government benefit checks for 3 or more days.

What's the effect of these long hold periods on consumers? It's more than an inconvenience. The financial cost to consumers is not minimal.

$135 MILLION A YEAR IN BOUNCED CHECK CHARGES

We have estimated, based on Federal Reserve data, about the proportion of checks that are bounced because of what are called uncollected funds, that over $135 million a year in bounced check charges are charged to consumers due to held checks. There are approximately 10 million checks a year that are written by consumers that bounce because the funds have been deposited but have not been made available to those consumers, and that is costing consumers $135 million a year in bounced check charges. Now that's just the charge that the banks put on the consumers for these holds.

Probably just as much is being charged to consumers by the utility companies, the telephone company, other creditors, other people they owe money to, who get these bounced checks and then impose a fee when the check does bounce. Those are common also. They tend to be about $10 or $15 per check. So the typical consumer who relies on a deposit to write a check and ends up bouncing that check because they think the money is available but the bank hasn't made it available may end up paying $15 to the bank and $10 or $15 to whoever the check was written to.

We want to stress that the burden of these charges is clearly borne disproportionately by low- and moderate-income families and by working families who are living paycheck-to-paycheck. These are the people who when they deposit a check into their account don't have a cushion to protect them. They rely on that particular deposit to pay for their day to day living expenses, for the rent or mortgage, for food, for utilities. They are the people who are harmed most when it takes them 1 week to get access to their paycheck or 1 week to get access to a Government benefit check.

As we will indicate in more detailed testimony, these long hold periods simply aren't necessary to protect the banks. There is no commensurate benefit to banks from holding these funds and for charging consumers this amount of money. And that's indicated by the fact that many banks don't impose such long holds.

[The complete prepared statement of the Consumer Federation of America, Consumers Union, and Public Citizen's Congress Watch follows:]

TESTIMONY OF

CONSUMER FEDERATION OF AMERICA

CONSUMERS UNION
and
PUBLIC CITIZEN'S CONGRESS WATCH

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

January 23, 1987

INTRODUCTION

Mr. Chairman and Members of the Banking Committee: Consumer Federation of America* Consumers Union**, and Public Citizen's Congress Watch*** appreciate the opportunity to testify today.

We want to begin by commending you, Mr. Chairman, for your dedication to consumer issues over your tenure on the Banking Committee. Your leadership has given consumers landmark legislation such as the Truth in Lending Act, and the Community Reinvestment Act. We look forward to working with you and your staff toward continued consumer progress this Congress.

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* Consumer Federation of America is a coalition of over 200 national, state and local consumer, senior citizen, labor, farm, cooperative and rural organizations which together represent over 30 million people.

** Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education and counsel about consumer goods and services and the management of family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 3.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

*** Public Citizen is a consumer research, lobbying and litigation organization with 80,000 members nationwide. Since its founding by Ralph Nader in 1971, Public Citizen has fought for product safety, a healthy environment and consumer rights in the marketplace.

We also commend Senator Dodd for his leadership on the check hold issue. We look forward to working with Senator Dodd on that issue, as well as others, in the Consumer Subcommittee.

Our testimony discusses the need for check hold legislation and other consumer issues that we urge the Committee to address this Congress. The testimony also discusses structural issues such as the "non-bank" bank loophole and the regulators' bill.

Our highest priorities for rapid action this session are Check Hold and Truth in Savings legislation. Check Hold bills have previously passed both Houses and a Truth in Savings measure passed the House last Congress. Action on holds and truth in savings is long overdue and we urge you to address these issues in the first piece of banking legislation that emerges from the Committee.

CHECK HOLD

Introduction

The resolution of the longstanding check hold issue is one of our highest priorities for early action this session of Congress. The check hold problem is not a new one to either the Senate or the House. As you know, the Subcommittee on Consumer Affairs of this Committee held hearings on the check hold issue in both 1982 and 1983. Hearings were held in the House in 1984 and 1985. The Senate passed a holds bill in 1984, but the House did not pass legislation that year.

In 1986, the House passed a strong holds bill by a vote of 282-11 that was supported by labor, consumer, neighborhood, and credit union organizations including the AFL-CIO, United Steelworkers of America, American Association of Retired Persons, National Conference of State Legislators and the National Association of Neighborhoods.

The Senate also passed legislation in 1986. Unfortunately, that action came very late, on the last day of the 99th Congress, and by that time a conference on the differences between the House and Senate bills was impossible.

We believe the check hold issue is ripe for swift action and urge this Committee to make sure that consumers are finally relieved from unfair holds practices through strong federal legislation.

The Problem

The extent of the delayed funds problem has been documented by consumer groups. A 1986 nationwide survey of 458 banks and savings and loans conducted by the U.S. Public Interest Research Group[1] showed that a majority of the institutions surveyed hold local checks for 3 to 5 business days. 76 percent said they hold out-of-state checks for six business days or more, and 20% said they hold these checks more than 2 weeks. The 1986 survey showed no improvement in the holds problem since an earlier study conducted by U.S. PIRG in 1985.[2]

Even cashier's and government checks are not exempt from long holds. 37 percent of the institutions in the U.S. PIRG study said they hold out-of-state cashier's checks for over a week and 8 percent hold these checks over two weeks. 17 percent say they hold government checks over three business days. A survey of 31 banks and savings and loans conducted by Public Citizen in 1985[3] found that 25 percent of Washington, D.C. area institutions place holds on U.S. Government checks. Half said they hold payroll checks.

Federal Reserve Board surveys, conducted in 1977, 1981, 1983, and 1985, showed that 14%, 25%, 13%, and 15% respectively of people with checking accounts have experienced delayed availability problems. The Federal Reserve figures yield an estimate of between 6.5 and 12 million consumers who have had problems when denied access to their funds. It is particularly disturbing that the Federal Reserve figures rose between 1983 and 1985 despite increased pressure on financial institutions to improve holds policies by both Congress and the public.

Long hold periods are a source of irritation, inconvenience and monetary loss for consumers. The most obvious hardship is the chronic delay in gaining access to needed funds. The whole purpose of depositing funds in a checking account is to have ready use of the money.

The hardship imposed by lengthy hold periods hits low and moderate income consumers the hardest. Figures presented by the Federal Reserve Board show that 40% of all families have less than $1000 in financial assets. Many of these people live from paycheck to paycheck and frequently need immediate access to at least a portion of whatever funds they receive to meet daily living expenses.

In addition to creating access problems, holds create monetary costs for consumers. Banks may impose high overdraft charges when checks are written on "held" funds. The Federal Reserve reports that 9.72 million checks were returned in 1981 due to holds imposed on deposited funds.[4] This means, based on an average bounced check fee of $14,[5] that consumers pay $135 million a year in overdraft charges alone due to holds.

It is impossible to estimate the additional costs to consumers because of check holds. We do not know how much interest is lost from interest-bearing accounts, nor how much consumers lose to late fees assessed by merchants and creditors because checks they write in good faith bounce when banks impose holds on their deposits.

The Check Clearing Process

The check clearing process is complex in practice but simple in theory. A deposited check is quickly forwarded from the bank of deposit to a clearinghouse, either a branch of the Federal Reserve or a large commercial bank. The clearinghouse sorts the checks it receives and routes them to the payor bank (the financial institution on which the check is drawn).

The clearinghouse, in addition to routing the check to the payor bank, credits the account of the bank of deposit for the amount of the check. Upon receipt of credit, the bank of deposit can immediately invest the funds even though these funds are withheld from the depositor. The Federal Reserve estimates that banks receive over $290 million a year because of this ability to take advantage of the float.[6] A law review article on the subject notes that one extra day of float for the banking system has been variously estimated to produce $800 million to $1 billion a year in revenue for the banking industry[7].

The timing for when the bank of deposit receives credit is based on availability schedules. These schedules reflect how long it takes, on average, for a check to travel to the payor bank for payment. The Federal Reserve reports that 99% of checks clear (the bank gets credit for the funds) in 1 or 2 business days. The rest clear in 3 days.

The Federal Reserve Bank of Richmond/Baltimore Branch availability schedule, for example, does not show a delay greater than 2 days regardless of whether the check is traveling to Philadelphia or Los Angeles. Consequently, in no case represented by the schedule would more than 2 days elapse before a bank had, and could use, the funds deposited by check.

In the vast majority of cases, the check is good and the payor bank pays the funds to the clearinghouse. The process is then complete. Banks do not receive notice that a check is good, nor do they wait for the funds to be paid, because they have already been credited by the clearinghouse.

If a check is bad, the payor bank does not typically notify the bank of deposit directly but rather returns the check by the same route as it was forwarded, to the clearinghouse and then to the bank of deposit. A bank of deposit must return the funds advanced by the clearinghouse if a check returns unpaid, though actual losses because of bad checks are minimal.

Because so few checks are returned, the return process, unlike the forward process, has not been automated. The forward process is extremely sophisticated and makes use of magnetic imprints on checks, high speed processing machines, jets, and overnight couriers so that banks can get credit and use of the depositors' money very quickly.

The return process relies on manual sorting processes rather than high speed automation. Moreover, the check retraces its forward path and consequently is returned through one or more clearinghouses before finally arriving at the bank of deposit. Each institution involved in the return of the check may delay until midnight of the day following the date of receipt of the check to start the return process, and even then, it often simply puts the returned check in the regular U.S. mail.

In most cases, the bank of deposit does not learn whether a check has been dishonored until enough time has passed to allow for the check to reach the payor institution and make its long way back. However, even after waiting 15 days, for example, for a check to return, the bank of deposit cannot be sure the check has been honored because the current system imposes an obligation to notify only in the case of dishonor. A mishap in the forwarding or return process can extremely delay receipt of that notice by the bank of deposit.

A History of Inaction by the Regulators and the Industry

The delayed funds availability problem has long been recognized. The Federal Reserve Board has studied delayed funds since 1977, the year the Board first conducted a consumer survey on holds. In February 1979, a joint task force of the American Bankers Association and the Federal Reserve Board found that "delayed funds availability is a widely employed and common banking practice," and recommended that banks make funds available to established financially responsible customers on a schedule at least equal to the receipt of credit by the bank of deposit.[8] In 1984, two years after the Senate held the first check hold hearings, the federal regulators issued a joint, non-binding policy statement encouraging institutions that delayed availability "to review and disclose their policies, and to refrain from imposing unnecessary delays on all checks, particularly on Social Security and other government checks."

Yet despite continued public outrage and Congressional prodding, neither voluntary efforts nor action by the federal regulators have provided relief for consumers. The studies conducted by the U.S. Public Interest Research Group in 1985 and 1986 document that lengthy holds continue to persist nationwide. In addition, as previously noted, Federal Reserve surveys show that the percentage of consumers reporting delayed funds problems increased between 1983 and 1985. Former Vice Chairman of the Federal Reserve Board, Preston Martin, commented on this increase in hearings before the House Banking Committee:

> The survey did not show any significant decline in the percentage of families reporting problems. In fact, the 1985 survey showed a slight increase in the percentage of families reporting delayed availability problems compared to the 1983 survey which we did. So we are not very positive with regard to the reports so far on the 1984 joint statement and the reviews that we have done on a voluntary basis.[9]

Under the pressure of legislation proposed in the 99th Congress, the banking industry came up with a new response. Now they claim that the check hold problem does not exist. In the past year, several "studies" of self-selected samples of financial institutions have claimed that only a minuscule proportion of checks are subject to holds.

Sampling and bias problems aside, these surveys fail to distinguish between deposits into consumer accounts and deposits into business accounts. Most checks are deposited not by individual consumers but by businesses and business accounts are not subject to holds. Consequently, the study reflects a large number checks that are irrelevant to this consumer problem.

State Legislation

Frustrated by the lack of improvement in check hold practices, states have begun to pass legislation. Eight states have adopted mandatory availability schedules: California, Connecticut, Illinois, Missouri, Massachusetts, New York, Rhode Island, and Wisconsin.

State legislation has not, however, been able to provide a solution to the check hold problem. The Federal Home Loan Bank Board issued an opinion on March 7, 1984 that the New York state funds availability law does not apply to federally-chartered savings and loans because of the preemption doctrine. A similar position was taken by the National Credit Union Administration in a regulation issued by that agency on February 1, 1985.

The Solution

We firmly believe that federal legislation is the only way to resolve the check hold problem. The general scheme for legislation should be to require banks to make funds available on a schedule that reflects the period required for the bank to receive credit for the category of check deposited, i.e., within 1-3 days after deposit. Specific exceptions should be provided from the mandated hold periods for situations that involve potential risk to the bank.

Some members of the banking industry argue that legislated reductions in hold periods should not occur until the check clearing system has been improved. A bank should not release deposited funds, this argument goes, until enough time has elapsed for it to be confident that the check has been honored by the bank on which it was drawn.

However, there is no need to delay implementation of a hold schedule that is based on receipt of credit by the bank of deposit. This is because the present use of long holds does little toward protecting a bank against loss that could not be achieved by allowing banks to impose such holds only in potentially high risk circumstances.

Long hold periods are based on crude estimates of the time it takes for any category of check to be presented to the payor bank and returned to the bank of deposit. However, these estimates do not protect a bank when a customer intentionally writes or deposits a bad check. Someone who wishes to defraud a bank by receiving cash for a check written on insufficient funds can do so now by tampering with the check's magnetic strip, which is used to make the check machine readable for sorting purposes during the forwarding process. This delays the check in its forward movement toward the payor institution, requiring the processing banks to handle the check by hand. Even the longest hold periods could be ineffective against this kind of scheme.

In spite of long holds, the present clearing process also leaves a bank vulnerable to losses on checks with forged signatures. Because of the large volume of checks, a payor bank does not usually have the time or resources to determine whether signatures are valid. At most, the payor bank is able only to check to make sure that endorsements and signatures are actually present. By the time a forged signature is discovered, which is likely to be at the time the customer reviews his monthly statement, even a lengthy hold period has already passed.

In fact, holds are not effective protection to banks against losses in many instances because dishonored checks arrive at the bank of deposit long after a hold period has expired. A three week survey of return items by a New York savings institution and summarized by the United States League of Savings Institutions in a 1983 Senate hearing showed that the forward and return process "almost always exceeded the hold period and usually by a significant number of days." The U.S. League notes:

> ... while the association uses the equivalent of a seven-day hold for items drawn on institutions in metropolitan New York, only 1% of checks returned by local institutions were received within the seven-day hold period. About 90% took at least 10 days to be returned, 54% took at least 13 days, and 10% took more than 15 days.
>
> The association had a similar experience with items drawn on institutions outside the metropolitan area. For these items, the association uses the equivalent of an 11-calendar-day hold. About 10% of these return items were received within 11 calendar days. About 60%, however, required at least 16 days to be returned and 10% took at least 20 days to be received.[10]

Moreover, the current level of losses is small and should not increase significantly under legislated hold periods because most consumers simply do not want to write bad checks and would "make good" on a bad check if they wrote one. The Federal Reserve reports that 99 percent of all checks are paid the first time through the collection process.[11] More than 60 percent of returned checks are for less than $100 and approximately half of all returned checks are paid the second time through the collection process. Most returned checks do not result in losses because the bank usually recovers from the depositor.[12] In the end, only one in 5,245 returned checks results in loss to the bank.[13]

The type of scheme we endorse has precedent both in law and industry practice. Massachusetts law, for example, requires two day availabilty for checks drawn on any bank in the entire New England area and four day availability on checks from outside the region. The law allows exceptions in specific circumstances that involve potential risk, including an exception for new account holders, for amounts over $2,500, for accounts that have repeated overdrafts, and for checks that raise a good faith doubt of collectibility. The law, which is not premised on any improvements in check processing technology, has been very successful. The Office of the Massachussetts Commissioner of Banks reports that there have been no problems due to increased losses as a result of the check clearing law.

In addition, some banks already have hold practices that are as short or shorter than what we urge. In testimony before the Banking Committee in 1983, Bank of America stated that it places holds, only on an exception basis, on less that 1% of the checks it receives. These holds are imposed only on a case-by-case basis depending on the risk of loss presented by a particular check. The 1986 study by the U.S. Public Interest Research Group, in addition to finding a high percentage of lengthy holds, also documented that 22 percent of the banks grant immediate access to local checks and 9 percent grant immediate access to out-of-state checks. Even the ABA-Federal Reserve Task Force that studied delayed funds availability in the seventies issued a report indicating the workability of this scheme. It stated that banks should "retain the flexibility to provide established, financially responsible customers with funds availability on a schedule at least equal to the receipt of 'provisional credit' by the bank without extending similar funds availabilty in situations that may involve crime or financially irresponsible individuals."

The Dodd Bill

We commend Senator Dodd for his leadership on the check hold issue over three Congresses and, particularly, for the holds bill he has introduced this session. This bill reflects the benefit of comprehensive hearings on the check hold problem as well as the successful experience in Massachusetts.

The Dodd bill requires the Federal Reserve Board to promulgate a delayed funds regulation within four years after enactment. In promulgating the regulation, the Board can choose one of two options.

One option is to improve the system for returning dishonored checks. Under this option, the funds availability regulation could allow no more than four intervening days between the day of deposit and the day of availability. The Board would tier the availability schedule based on the forward and return times applicable to particular categories of checks. This option provides three exceptions to the mandated availability schedule: for checks where the bank of deposit has a reasonable suspicion to believe that the check is uncollectable; for emergency situations such as suspension of payments by another depository institution; and in cases where the Federal Reserve temporarily suspends the availability schedule due to fraud losses for a particular class of checks.

Option two is that the Federal Reserve would issue an availability regulation without improving the return system.

As with the first option, this regulation could allow no more than four intervening days between the day of deposit and the day of availability. However, the Board would tier the schedule based on the time needed for the bank of deposit to receive credit for the check, considering the geographic location and type of institution involved, and type of instrument.

Option two would allow the Board to promulgate additional exceptions to the availability schedule including, exceptions for new account holders, large dollar amounts, accounts that have been overdrawn repeatedly, checks that have been returned unpaid and redeposited, and any other class of checks where the Board finds, based on substantial evidence, that such class poses a serious risk of loss to depository institutions. In addition, the three exceptions from option one would apply to this option as well.

We support the basic scheme in the Dodd Bill, though we have some suggestions for improvements.

First, the availability schedule that we have referred to as option two, should become effective very quickly instead of four years after the bill is enacted. Option two is workable today without improvements in technology because it relies on exceptions to protect banks from undue risk. Short of expeditious implementation of option two, we believe the bill should require the Board to set a temporary availability schedule that lasts until the final regulation becomes effective. A temporary schedule would provide consumers immediate relief from some of the most eggregious holds practices instead of postponing any protections for another four years. The temporary schedule would also allow the banking system to gradually make the transition into reduced hold periods.

Second, with respect to the exceptions allowed under option two, the exceptions for new account holders and for large dollar amounts should be set by statute rather than leaving them to the Federal Reserve Board to define, especially given the disinterest the Board has shown toward the check hold problem. Both are exceptions that are of particular importance to consumers in terms of the overall benefit of the law. We believe a holds bill should set the new account holders exception at 30 days and the large dollar amount exception at $5000. Four of the state laws have a 30 day new account holder exception, and Connecticut only extends the exception to the opening deposit for a new account. Missouri sets the large dollar exception at $5000 and Illinois, Wisconsin and Connecticut have no limit at all.

Third, one class of persons that consistently has serious holds problems are new account holders. Even though we support a new account holder exception, we also believe that a holds bill must provide ready access to some funds for these persons, at least through cashier's checks.

Lengthy holds on cashier's checks are particularly unjustified because these checks are drawn by a bank on the bank's own funds. Moreover, the consumer typically pays for a cashier's check based on the expectation that the check will be treated as cash. This reasonable expectation should be fulfilled by applying the bill's mandated availability schedules to new accounts.

TRUTH-IN-SAVINGS

Introduction

Adequate information is essential to a fully functioning and efficient market. In the past, strict regulation of deposit accounts presented consumers comparing different accounts with a relatively straightforward task. Account terms varied little and competition between depository institutions and other providers of similar services was limited.

Today, the terms, conditions and prices of deposit accounts are almost completely unregulated, and consumers are faced with a widening variety of bank services. This transformation of the market has benefited those consumers with adequate resources to take advantage of their new options. For most consumers, however, the expansion of options has not been matched by the expansion of information necessary to evaluate options and make informed choices.

A market cannot operate efficiently if buyers of services are routinely unable to determine the prices and compare the value of competing services. Consumers today have a great deal of difficulty acquiring information, and greater difficulty comparing what information is available from competing institutions. The result is an inefficient market that fails to reward providers of the best values, fails to penalize deceptive behavior, and fails to allow consumers to influence market behavior through rational purchasing decisions.

Two Parts to Adequate Disclosure

Two types of disclosures are needed to allow consumers to compare account offerings: Accurate and uniform disclosure of interest income on deposit accounts, and disclosure of all the potential costs of consumer accounts. Legislation should be drawn to provide consumers with the full picture -- accurate, concise, comparable information on the costs and benefits of deposit accounts.

Income Disclosure
Rate and Yield Disclosures

We recommend that truth-in-savings legislation require banks to make a standardized disclosure of several yield-related terms. These should include the annual rate of simple interest (ARSI), the method of compounding, and most importantly, the annual percentage yield (APY), which should be uniformly defined to reflect the application of the annual rate of simple interest and the compound period to a $100 deposit over a 365-day year.

However, the APY disclosure generally assumes that a single rate will apply for a full year and that funds will be left on deposit for a full year. The legislation should require a tailored APY disclosure in special cases where this assumption is inappropriate. These include:

*Time deposits of less than one year, where use of an APY may misleadingly suggest that the deposit may be rolled over at the same rate.

*Accounts with variable interest rates linked to market indices or, more commonly, varied periodically according to the judgment of bank managers.

*Introductory or "teaser" rates that apply for a short time, after which a lower or a variable rate takes effect.

*Tiered rate accounts, on which different rates of interest are paid on different balances.

*Combinations of any of the above, such as tiered rates where one or more tiers pay variable rates or variable rate accounts with introductory teaser rates.

As a general rule, disclosures for accounts with featuressuch as these must include enough information for a consumer to fully understand these features, as well as related information such as balance requirements necessary to receive a particular rate of interest.

The Need for a Standardized Balance Calculation Method

As consumer organizations have stressed for years, different methods of calculating the balance on which interest is paid have a significant impact on an accounts' yield, which is not, and cannot be, incorporated into the APY.

Most consumers assume that interest is paid on a day-of-deposit to day-of-withdrawal basis or on a daily basis. But interest may be paid on the basis of a variety of other balance calculation methods, including a low balance method, where interest is paid only on the lowest balance in the account on any one day of the month. The effect of this technique may be to eliminate interest earnings altogether

When different balance methods are used, comparison between accounts becomes impossible. It is not enough to know that two accounts each have yields of 5.65%. The question consumers need answered is "5.65% of what?"

Simple disclosure will not remedy the problem caused by banks' use of varying balance calculation methods. First, our repeated inquiries have indicated that few, if any, members of the banking industry itself understand and can articulate the differences between the methods used now. This bodes poorly for the ability of consumers to understand balance calculation method disclosures. Second, even if consumers clearly understood that the average daily balance calculation method was more advantageous than the first-in first-out method, for example, they are highly ill-equipped to calculate the comparative value of accounts with differing APYs and differing balance calculation methods.

The only clear solution to this important problem is a legal requirement mandating use of a single method for calculating all balances used to determine interest payments on deposit accounts. If balance calculation methods are not standardized, consumers will not be able to use the other account disclosures to accurately compare accounts.

Truth in Savings legislation should require use of the average daily balance method. This method is fair for consumers because it requires banks to pay interest every day funds are in the account. Because banks themselves earn interest each day a depositor's funds are on account, that same benefit should be passed on to consumers.

By deregulating interest rates on deposit accounts, Congress made the policy decision to promote competition in deposit services. However, true competition will continue to be impaired until consumers are given the means to accurately compare among competing product claims, and standardization of balance calculation methods is a prerequisite to comparison shopping. We do not allow retailers to define weights and measures any way they wish, and we recognize that variations in weights and measures do not promote but impede true competition. Balance calculation standardization would serve as the true weights and measures law of financial services.

Fees Disclosure

Even full disclosure of interest yield no longer gives consumers a complete picture. Interest yield is gross, not net, income. In recent years, disclosure of account fees has become especially important in evaluating consumer accounts because these fees have skyrocketed. The Federal Reserve Board reports that, between 1979 and 1983, fees on accounts doubled. The Board estimates that in this same time period these fees increased at a rate of between 2 to 4 times the increase in the cost of living.

Consumer Federation of America's annual surveys of account fees have revealed that these increases are continuing. The surveys found that the cost for moderate usage of a small NOW account increased 13% between 1984 and 1985 and increased an additional 12% between 1985 and 1986.

Fees are also becoming more numerous and more complex. In addition to relatively well-known fees -- monthly charges on accounts with balances below a certain minimum and bounced check charges -- fees are now charged in some instances for automatic teller machine transactions and for depositing a check that is returned for insufficient funds. Many institutions charge fees for each check written in addition to a monthly fee. And the monthly fee may be tiered depending on account balances, with as many as five different rates assessed on different balances. In some cases, fees are charged based not on the minimum balance, but on the number of transactions in a month.

CFA's most recent survey of fees, conducted in April 1986 at 225 banks and savings and loans in 18 states and the District of Columbia, revealed some new and imaginative ways of charging for deposit services. Some banks charge not for each automatic teller transaction but charge monthly or annually for use of an ATM card. These charges range as high as $18 per year. One institution with a $7 monthly charge for failure to meet a balance requirement also charges an additional $10 per month should the consumer desire return of cancelled checks. Several charge more for teller visits than for ATM transactions, or impose hefty monthly fees if the customer talks too often with a human teller. A number of other banks have gone beyond charging consumers for withdrawals and charge as well for each deposit.

Consumer organizations that have attempted to survey these fees have invariably found that they are unable to get accurate information from employees in branches, where consumers go to ask questions and open accounts. As Ken McEldowney, Executive Director of San Francisco Consumer Action, told an American Bankers Association conference in 1985:

> It seems clear to us that the communication of facts about prices, rates and basic bank policies has a very low priority at most banks. Even banks which publish brochures that are otherwise excellent often leave out prices. For 12 years, we have been presented with confusing, misleading and downright incorrect answers every time we tried to obtain information at the branch level.

As a result of our experiences with fee surveys and from consumers' experience with inadequate or misleading fee and interest rate information, we believe that voluntary disclosures have not and will not work. The commitment on the part of the banking industry industry is lacking.

Moreover, voluntary efforts will not produce the standardization of format and terminology needed to allow consumers to make informed choices. This standardization is needed because few consumers can become experts in the business of placing investment or deposits. Consumers make such choices infrequently in a market that may change rapidly, and which is at times barely comprehensible even to those who observe it closely. Consistent terminology and consistency of disclosures cannot evolve from the market. Consistency can only be mandated by regulation or legislation. Mandated terms and formats for disclosures need not be costly to develop and should ease banks' compliance problems by providing a simple format for meeting such requirements.

Truth in Savings Legislation

The Account Schedule

Truth-in-Savings legislation should require each depository institution to maintain a written schedule of the fees, charges, terms and conditions governing its accounts. Disclosure of the fees and conditions pertaining to deposit accounts is essential to rational consumer shopping and the efficient functioning of the market. To be useful to consumers, these disclosures must meet three requirements:

1) They must be comprehensive. Not only must every fee be disclosed, but other relevant terms, such as balance levels, must be disclosed as well. Disclosure standards for variable rate accounts such as Money Market Deposit Accounts must be developed.

2) The terminology must be consistent. Congress should require the Federal Reserve Board to define the terms used in the schedule so consumers will have confidence that when two disclosures use the same terms they mean the same things.

3) The disclosures must be consistent in format. Disclosure forms, left to the imagination of marketing departments, have resulted in slick brochures with information buried in reams of useless text. If consumers are to use disclosures to compare accounts, the form as well as the substance of the disclosures must be consistent. A simple chart, separate from distracting text, would allow consumers to place the disclosures of two banks side-by-side and make comparisons.

The law must ensure complete disclosure when interest rates or fees are split by time, balance, or account activity. Full disclosure of every level of each such term is necessary. Special provisions are also needed for disclosures of the return on variable rate deposit accounts such as Money Market Deposit Accounts (MMDAs). At a minimum, disclosures should clearly indicate that the interest rate is variable and cannot be guaranteed; what the basis and frequency of the variation are; and consistent historical data about the performance of the account.

Advertisements

Truth-in-Savings legislation should separately address the disclosures required for account advertising. These disclosures need not be as comprehensive as the full disclosures necessary in account schedules, and the disclosure requirements should only be invoked when an advertisement refers to an account's yield.

In advertising the APY is the most important yield figure because it incorporates both the interest rate and the effect of compounding. Unlike an ARSI disclosure, the APY disclosure will allow consumers to compare apples with apples. Although knowledgeable consumers can derive the APY if they know both the ARSI and the frequency of compounding, most consumers cannot. Most consumers are also so unfamiliar with financial terminology and concepts that they do not know which figure is more relevant to yield when confronted with both the ARSI and APY.

Conclusion

Accurate and comparable information about bank account terms is vital if the market is to operate efficiently. Consumers can and will use this information to discipline poor performers and reward good performers. Voluntary disclosure efforts are not working, and cannot work because they cannot produce the level of standardization of terminology or format necessary for the average consumer to use these disclosures effectively.

CREDIT CARDS

Five years ago, interest rates of all sorts reached record levels. The prime rate topped 20%. The discount rate reached 14%. Three-year Treasury Security constant maturities climbed over 16%.

Today, all of these rates have dropped substantially. Most interest rates are less than half what they were in 1981. But credit card interest rates are today higher than they were in 1981. In August 1981, according to the Federal Reserve, credit card plans offered by a sample of commercial banks averaged 17.8% In November 1986, those plans charged interest of 18.1%.

Even this average understates the costs of credit cards to the American consumer. It is a simple average of the rates charged by a small, self-selected pool of card issuers. More complete information, weighted by the number of cards issued by each bank, indicates that the average consumer is charged over 19% for use of a bankcard.

The Cost to Consumers

Consumers today owe about $85 billion on bank credit cards, an increase of 150% in just four years. In 1987, consumers will pay about $15 billion in bank card interest and annual fees, or over $1 billion each month. A reduction in credit card interest rates just to the early 1980 level of 17.13% could save consumers over a billion dollars a year in interest charges.

Credit card costs are thus of vital concern to American consumers. Consumers have waited patiently for credit card rates to decline to reflect reductions in the cost of funds. Today, the consumers we hear from tell us their patience is wearing thin. The token responses of a few banks are insufficient; it should not be page one news when a bank sets its credit card rates at a reasonable level.

Why rates are too high

Interest rates on credit cards are too high because there is insufficient true competition in the market, and because consumers are not provided with information they need to choose between competitors. The result is not only a market in which prices are too high, but one in which consumers are unable to determine the true cost of the service they purchase.

Bankers recognize that the market works to their advantage and that high interest rates can thus be charged to consumers with impunity. They have few incentives to reduce rates, because costs can so easily be passed on to consumers. In fact, some banks are taking advantage of high interest rates to market credit cards to less and less creditworthy customers. All consumers, not just these new customers, pay the costs of that marketing in higher interest rates.

The cost of funds

We do not disagree with the statement that credit cards, as unsecured loans, will carry higher rates than secured loans to reflect their greater risk. But the cost of funds is an important element in the cost of extending credit through credit cards, as banks were quick to point out when that cost was increasing. Even after dramatic reductions in the cost of funds, that cost is still 40% of the cost of offering a bank card. Credit card rates would, if the market were functioning properly, decline to reflect dramatic decreases in the cost of funds over the past four years.

The pricing of credit cards was adjusted in many different ways when the cost of funds was increasing. These pricing changes included factors other than interest rates. Annual fees, in particular, were widely introduced several years ago to compensate for banks' inability to raise interest rates to reflect increases in the cost of funds. As the cost of funds has decreased, annual fees have not come off. In fact, annual fees and miscellaneous charges are continuing to increase.

Imperfect competition

The fact that rates have not come down to match reductions in costs is as good an indication as any that competition and the market are not functioning properly. We should not confuse the existence of a large number of providers of a service with the existence of competition. A large number of providers constitute a necessary, but not a sufficient, condition for a competitive market.

Competition is imperfect in all markets for consumer credit becuase of the disparity in information and market power between the offeror of credit and the consumer. The National Commission on Consumer Finance stated in 1972 that "the statistical evidence considered here indicates that competition cannot be relied upon...to establish rates at reasonably competitive levels in many states."

Credit cards, as well as other forms of open-end credit, present some conditions which make competition even more difficult than for other forms of credit. Annual fees lock consumers in to a particular card for an entire year. The open-end nature of the agreement makes a calculation of the true costs of credit difficult; fees cannot be rolled into the interest charge for a single, accurate annual percentage rate figure. Perhaps most important, the cost of open-end credit cannot be reduced to dollars and cents before an agreement is

entered into as the costs of other credit contracts can. When all is said and done, the purchasers of a new home or a new car or a refrigerator compare figures for monthly payments more than they do APRs. But credit card plans by their nature cannot provide comparable information. In addition, most consumers are simply unaware of what market does exist. There is a general assumption, for example, that all Visa cards are identical.

These are not arguments to restrict the use or availability of credit cards, but they do point to reasons why the market functions differently, and less competitively, than for other forms of consumer credit. Public policy should take these conditions into account, and not simply rely on a market which does not exist.

All consumers pay for risky credit extensions

Lack of meaningful competition has other implications for the costs of credit as well. We believe that banks have not responded aggressively to bank card fraud and have accepted accounts with higher probabilities of default because they can pass these costs on to consumers without risking loss of business. Restrictions on interest rates and other bank card costs may provide the incentive banks need to reduce both fraud and bad debts.

The connection between high interest rates and bank tolerance of fraud is well-documented. The Lexecon report prepared in 1986 for the American Bankers Association, MasterCard, and Visa, entitled Interest Rate Controls on Credit Cards -- An Economic Analysis even goes so far as to argue that increased charge-offs are a healthy sign. Table 5 of the report (page 53) shows Visa charge-off rates in states with no interest rate controls to be over 50% higher than charge-offs in states with moderate or strict rate controls. "This indicates," the report says, "that unregulated bank card programs are much more likely to take business risks in order to supply cards to a greater number of consumers." It would be more accurate to say that creditworthy consumers are bearing the costs of those risks by paying banks tens of millions of dollars in excessive interest charges.

Better disclosure needed

Banks can pass these costs on to consumers because most consumers simply do not know what they are paying for the use of their credit cards. Consumers do not receive clear information about credit card costs when they are asked to apply for credit cards. Current law provides for most disclosures only after the consumer has applied for and received a card.

Credit card solicitations sometimes include the amount of the annual fee and the interest rate, but these disclosures are rarely clear or conspicuous. They commonly appear in fine print on the back of the application, an application which is smothered in several pages of glossy four-color hype. Important terms such as late fees and other charges and the method of calculation of balances on which interest may be paid are not disclosed.

As a result, applying for a credit card is a little like playing the lottery. Consumers do not find out what they need to make an informed choice until they have applied for and received the plastic card itself. Congress should adopt requirements that all the conditions of credit cards be spelled out to a consumer in all promotional material that includes an application for credit.

Balance calculation methods

Even when consumers have good information about the basic pricing factors -- interest rate, periodic fee, grace period -- they still cannot compare the dollars and cents costs of different credit cards. A variety of conditions, some due to the nature of open-end credit, some due to insufficient disclosures, contribute to consumers' inability to determine the true costs of credit card use. One important factor is the impact of different balance calculation methods.

We all tend to think of credit costs purely in terms of interest rates. The assumption is that since 18% is less than 21%, a card with an 18% interest rate will cost less than one with a 21% rate.

A report prepared for the Virginia General Assembly by the Colgate Darden Graduate School of Business Administration of the University of Virginia, entitled Credit Card Billing Practices in Virginia, illustrates the large effect balance calculation methods have on costs to consumers.

The report demonstrates the costs consumers might bear under four balance methods permitted by Virginia law. On accounts with identical patterns of activity -- a $400 previous balance, $300 payment, and $50 purchase at 18% during one month -- the finance charge ranged from $1.50 to $6 -- a factor of four. The effect of these different balance calculation methods is far greater than the effect of even relatively large changes in the interest rate. An account using the most expensive method, the previous balance method, would have to have its interest rate reduced all the way down to 4.5% to result in finance charges as low as the least expensive alternative, the adjusted balance method, and the rate would have to drop to 11.25% to match the cost of even the second most expensive alternative. Conversely, an account with an adjusted balance method could bear an interest rate of up to 72% before it would match the costs of the 18% previous balance method account.

Recommendations

We believe that Congress should establish federal standards for credit card pricing. Credit cards, more than any other form of consumer credit, are marketed across state lines by banks which take advantage of favorable conditions in some states to create an interstate market.

In the past, we have opposed Federal preemption of state interest rate ceilings. We believe that the states have acted responsibly to balance the needs of creditors and consumers in the market for credit. Credit cards differ from other forms of consumer credit in that a national market has been established in which offerors of bank cards market those cards in a manner which restricts the States' ability to regulate the cost of credit within their borders.

The most expensive credit cards on the market today are those marketed nationally by banks working from a single state with unusually high or no interest rate ceilings. Congress could reduce credit card costs and place control of those costs at the appropriate level if it required banks to abide by interest rate ceilings in the state of residence of the consumer. Offerors of gasoline and other retail credit cards must abide by such limits currently.

If a national interest rate ceiling is established, Congress should be careful to ensure that other charges or conditions cannot be changed to thwart the intent of such a ceiling. There is probably little danger that annual fees can be increased substantially; consumers are very sensitive to annual fees because they can be so easily compared. But many consumers would not be served if interest rates were reduced but grace periods for payment were removed. Restricting interest rates without restricting banks' ability to shift costs in this manner would not be seen as positive legislation by consumers.

Improved disclosure is needed to allow consumers to compare competing cards. The Truth in Lending Act should require each solicitation which includes an application for a credit card to include a standardized table showing fees, interest rates, and conditions under which fees or interest may be charged. The table should include all ways in which consumers might have to pay for the use of a credit card, and fees not disclosed in the table should be prohibited.

These disclosures will not be useful unless balance calculation methods are standardized. All the disclosures in the world will not allow a consumer to compare costs when balance calculation methods are uncontrolled. The complexity of these different methods, and the many permutations designed by lenders, do not lead to further disclosure requirements as a solution. Credit card offerors should be required to use a carefully defined average daily balance method to calculate the balances against which finance charges may be imposed. Standardization of balance calculations, coupled with full disclosure of all fees and charges, will give consumers a chance to make the market work.

PROBLEMS IN THE MORTGAGE MARKET

Speaking on behalf of homeowners, and those who hope to become homeowners, we are particularly heartened by your return, Mr. Chairman, to the helm of the Senate Banking Committee. During your earlier chairmanship, you addressed many of the problems consumers experience in the home finance market. We are eager to work with you, the Chairmen of the appropriate subcommittees, and all the members of the committee to resolve some of the insidious problems that remain. We hope that prompt hearings will be held on these issues and that they will provide the information and impetus to move remedial legislation forward during this year.

Shopping for a Mortgage Is A Game of Russian Roulette

The Problem

Under current law and industry practice, the process of obtaining the financing required for homeownership is inordinantly unpredictable and downright abusive. The market provides no certain means for consumers to learn at the preapplication stage whether the current terms of a mortgage will remain fixed through the date of settlement. As a result, comparison shopping is greatly impaired and consumers are subject to undue strain and unexpected costs. Consumers are forced to blindly apply to any particular lender on the hope that the favorable mortgage terms discussed at the preapplication stage will be the same terms incorporated in the mortgage document. Frequently, this hope is shown to be unfounded.

We have interviewed real estate brokers, consumer advocates, consumers, former lenders and settlement attorneys, all of whom describe as "not unusual" the following scenario: Consumer A contacts a mortgage lender to inquire about terms. The lender indicates that it has mortgage loans at a competitive rate, and the consumer assumes, reasonably or unreasonably, that the quoted price terms will remain fixed through settlement. After anxiously awaiting the date of settlement and counting pennies to assure that the monthly

mortgage costs will be affordable, the settlement date finally arrives. At closing, the lender's representative suddenly informs those present that the points and/or interest rate have increased. Faced with the alternative of losing the property he is trying to finance, Consumer A swallows his indignation, shock, and/or panic and signs on the dotted line.

This classic scenario is "played out" in several specific circumstances. In some cases, the borrower simply does not understand the traditional norms within the mortgage industry. One characteristic norm is most succinctly described as "the oral tradition," or the practice of lenders to provide only oral statements of the conditions surrounding the application process.

In some cases about which we have anecdotal evidence, lenders orally assure the consumer that the rate and point charges are locked-in, presumably indefinitely. When these terms are changed at closing, the surprised borrower has little to rely on but his word against the lender's. In other cases, it seems, the question of whether a quoted rate is a set rate does not explicitly arise at the application stage. Although the borrower assumes the stated terms are set, the assumption within the industry, about which the borrower is unaware, is that terms quoted at the time of application are subject to change until they are formally locked in.

This assumption appears to be shared by many, including the Federal Reserve Board. For example, the Truth-in-Lending regulations for residential mortgage transactions require lenders to disclose such loan features as the annual percentage rate within three days after a loan application is received. They are broadly permissive in explaining the conditions under which these disclosed terms may be altered at closing: "If a disclosure becomes inaccurate because of an event that occurs after the creditor delivers the required disclosures, the inaccuracy is not a violation of this regulation, although new disclosures may be required...12 C.F.R. Section 226.17(d). The regulations accommodate the industry norm under which terms that are disclosed at an early stage are later nullified at closing by merely requiring the lender to subsequently disclose the actual terms of the loan "no later than consummation or settlement." 12 C.F.R. Section 226.19(b).

The general observations and anecdotes related to us by persons in regular contact with the lending industry were corroborated last summer by Brian Sharry, a former loan originator, who testified last summer before the Housing Subcommittee of the House Banking Committee. In his testimony, he described how his former employer, a mortgage finance subsidiary of a bank, brazenly but routinely reneged on its commitments to originate loans according to pre-set terms by sitting on the application until the lock-in period expired. He also described how this protracted application strategy was

The **Chairman**. Thank you very much. Your timing was perfect. It was just 5 minutes. I didn't even have to announce it in advance. I should have and I neglected to. There is a time limit on oral presentations.

Ms. Livingston, go right ahead.

STATEMENT OF FRANCI LIVINGSTON, STAFF ATTORNEY, CONGRESS WATCH

Ms. **Livingston**. Thank you, Mr. Chairman.

I appreciate the opportunity to testify this morning and I would like to echo Alan Fox in commending you for your dedication to consumer protection during your tenure on the Banking Committee.

I will confine my statement to our recommendations for Federal check hold legislation.

Consumer Federation of America, Consumers Union, and Public Citizen's Congress Watch strongly believe that Federal legislation is the only way to stop the unjustified holds placed on consumer funds deposited by check.

The scheme for legislation we urge is to require banks to make funds available when they receive credit for the type of check deposited. This schedule would mean the customers would get access to their funds when the bank does, within 1 to 3 days after deposit.

EXCEPTIONS TO PROTECT BANKS

To protect banks in situations involving potential risks, the schedule should have exceptions from the mandated hold period. These exceptions would include, for example, an exception for new account holders, for large dollar amounts, and for accounts that have repeated overdrafts.

This scheme properly focuses on the fact that the vast majority—99 percent of checks—are good, but provides exceptions for those instances where a bank may be at risk.

To understand how banks get the money consumers deposit by check in 1 to 3 days requires a brief description of the check clearing system.

The check clearing process is complex in practice but simply in theory. A deposited check is quickly forwarded from the bank of deposit to a clearing house. The clearing house sorts the checks it receives and routes them to the banks on which they are drawn. The clearing house also credits the bank of deposit for the amount of the check. Upon receipt of credit, the bank can immediately invest the funds even though these funds are withheld from the depositor.

The Federal Reserve estimates that banks receive over $290 million a year because of their ability to take advantage of this float.

The timing for when the bank of deposit receives credit is based on availability schedules. These schedules reflect how long it takes on average for a check to travel to the payer bank for payment. The Federal Reserve reports that 99 percent of checks clear—that is, the bank of deposit gets credit for the funds—in 1 or 2 business days. The rest clear in 3 days.

In the vast majority of cases, the check is good and the payer bank pays the funds to the clearing house. The process is then complete.

If the check is bad, the payer bank does not typically notify the bank of deposit directly but rather returns the check by the same route as it was forwarded, an exceedingly slow process. The bank of deposit must return the funds advanced by the clearing house if a check returns unpaid, though actual losses because of bad checks are minimal.

The type of scheme we endorse has precedent both in law and industry practice. Some banks already have hold practices that are as short or shorter than what we urge. In testimony before the Banking Committee in 1983, Bank of America stated that it places holds only on an exception basis on less than 1 percent of the checks it receives. These holds are imposed on a case-by-case basis depending on the risk of loss presented by a particular check.

Even the American Bankers Association/Federal Reserve task force that studied delayed funds availability in the 1970's issued a report that indicates the workability of this scheme. It stated that banks should retain the flexibility to provide established financially responsible customers with funds availability on a schedule at least equal to the receipt of credit by the bank without extending similar funds availability in situations that may involve crime or financially irresponsible individuals.

MASSACHUSETTS SYSTEM IS A GOOD MODEL

Finally, Massachusetts law provides a model for the workability of this scheme. That law requires 2-day availability for checks drawn on any bank in the entire New England area and 4-day availability on checks from outside the New England region. Exceptions are allowed in specific circumstances that involve risk.

That law, which is not premised on any improvement in check processing technology, has been very successful. Last August, the Massachusetts Commissioner of Banks conducted an informal telephone poll to determine if there had been any increased losses by banks as a result of the regulation. The parties in the survey included the Federal Reserve Bank in Boston, banks, and trade associations. Said Commissioner Bulman of this survey:

> The overall response was favorable. The regulations are considered fair to both consumers and banks. No documentable instance of loss could be attributed to the regulations.

Michelle Meier will further elaborate on why bad check losses are not an argument against the scheme that we endorse.

The Chairman. Thank you, Ms. Livingston.

Ms. Meier.

STATEMENT OF MICHELLE MEIER, LEGISLATIVE COUNSEL, CONSUMERS UNION

Ms. Meier. Thank you, Mr. Chairman.

I would also like to congratulate you for your resumed chairmanship of the Senate Banking Committee and all of us are very excited about working with you in the 100th Congress.

The constant refrain that we have heard and that I'm sure you will hear about the check hold issue from the industry is that mandated check hold legislation will increase losses to banks.

Our research and the industry research that we have relied on has brought us to the very strong conclusion that this allegation is simply false. We believe that the system that Ms. Livingston described of a 1 to 3 day mandated hold schedule with exceptions will pose no increased risk of losses to the banking industry.

This conclusion is based on the fact that lengthy holds are ineffective protection against losses caused by bad checks at the present time.

To understand this, you have to have a little better understanding or a more detailed understanding of the check clearing system than was described by Ms. Livingston, which is the purpose of my testimony.

CHECK RETURN SYSTEM

Most specifically, one has to understand the check return system. As Ms. Livingston explained, that system is exceedingly slow. It is based on the premise that a bank of deposit will not learn that a check is bad or has been dishonored by the payer bank until it is actually returned to the bank of deposit.

In fact, a long hold period can actually pass before the bank of deposit can receive this information. This is due to the exceedingly slow, nonautomated nature of the return system. That return process is very slow and nonautomated because so few checks actually are returned—less than 1 percent of all checks that go through the check clearing system.

Most checks don't return to the bank of deposit even within the time needed for a long hold period to pass. This was documented in a study by the U.S. League which was presented before this same committee in 1983. The results of that study showed that with local checks only 1 percent of those that did return returned within 7 days after the check was deposited. Only 10 percent of nonlocal checks that were returned returned within an 11-day hold period.

These long time periods needed for the check to return can even be lengthened in cases of intentional fraud. Someone can tinker with the microencoding that is used to forward the check to the payer bank and impede that quick movement and exceedingly delay the time period needed for the check to return to the bank of deposit.

Our conclusion that lengthy holds are ineffective protection now has brought us to the scheme that we strongly urge at the present time. If lengthy holds don't protect against bad check losses, then the scheme that we promote of 1 to 3 days availability with exceptions will not increase bad check losses to the banks.

What I have described at this point involve situations in which the payer bank actually dishonors the check and returns it to the bank of deposit. In some cases in fact, the payer bank will not even know that the check is bad. For instance, in cases in which there is fraud involved in the signature, where there is a forged signature, banks do not routinely examine the checks that they receive to determine whether or not signatures are authentic. This process is computerized. So frequently it will only be when the customer reviews his monthly statement that a forged signature will be detected. Again, in this circumstance, a lengthy hold will serve no purpose in protecting the bank against loss. The customer will have to, after a month, notify the payer bank and only then will the forgery be discovered and the lengthy hold period, of course, will already have passed.

We believe the preceding analysis makes our point that an expedited availability schedule legislated in law will not increase losses to banks. The information Ms. Livingston also relayed about the empirical experience of the industry members themselves and the experience in Massachusetts presents empirical evidence to emphasize our points.

In closing I would also like to state, Mr. Chairman, that we hope that the check hold legislation and truth-in-savings legislation which has long been an important item on the consumer agenda will move quickly with the first banking legislation that moves through this committee.

Thank you very much.

The CHAIRMAN. Thank you very much. This is a critical issue and a lot of people haven't realized the dimensions of it. You say, Mr. Fox, that just in bounced checks caused by the failure to clear checks that there are 10 million such checks at a cost of $135 million a year. Is that right?

Mr. FOX. That's correct. Just in the bounced check charges assessed by the banks to consumers, that's right.

The CHAIRMAN. Now I'd like to ask Ms. Livingston, I'm not clear in my mind whether you are recommending that we have a time limit for check holds specified in law or through regulations. In other words, should we act in the Congress to pass a law in this respect or should we simply direct State regulators to set up their check hold time limits, or the Federal Reserve?

Ms. LIVINGSTON. We believe that Congress should act in setting up an availability schedule and we could see this working in one of two ways. One would be for——

The CHAIRMAN. Let me just interrupt to say you mentioned I think Massachusetts. Has Massachusetts acted that way?

Ms. LIVINGSTON. There are eight States that have acted to date. Five of them have acted by statute and three of them have acted by regulation. Massachusetts acted by regulation.

PROCEDURE OF IMPLEMENTATION

The CHAIRMAN. But you would prefer to have the action by statute and why again? I interrupted you. I'm sorry.

Ms. LIVINGSTON. We see two ways that the availability schedule could be put into effect. One would be for Congress to actually write the availability schedule into law. Another would be to set an outside limit and then the Fed could fill in the actual schedule based on standards that Congress would set.

The CHAIRMAN. And which would you recommend of the two?

Ms. LIVINGSTON. I think either would be acceptable to us.

The CHAIRMAN. Any difference of opinion, Ms. Meier or Mr. Fox?

applied to applications on which no lock-in commitments had been made:

> With some applications, where the rate was to be set at time of commitment, final approval was deliberately delayed to coincide with a rate increase. I was told by Company Underwriters that many loan files, which had been recommended for approval by the Underwriting Department, sat in stacks in the President's office waiting only for his initials or those of another Senior Officer. I experienced delays of up to ten days between Underwriting Department approval and "final sign-off." "Mortgage Foreclosures and Other Current Mortgage Credit Issues," Hearing before the Subcommittee on Housing and Community Development of the Committee on Banking, Finance and Urban Affairs, U.S. House, 99th Congress, 2nd Sess. (July 23, 1986) at 109.

To some extent these types of abuses can be attributed to "bad apples" within the lending industry. But we believe the causes of the problem are systemic. For example, the common industry practice of communicating orally and incompletely fosters misplaced reliance on the part of the consumer. There are no broadly applicable laws requiring lenders to end this confusion by making written disclosures before application of the conditions under which the lender will operate from the point of application through the date of settlement.

Another systemic problem is the common lender practice of offering a locked in rate for only a finite period of time. This allows the lender to hold all the cards, and, given the right set of circumstances, it can leave consumers holding a very heavy bag. The experience of last summer offers a great example of this.

The summer of 1986 was characterized by a significant drop in mortgage interest rates that sent a deluge of consumers into the mortgage market. Many loan applicants formally or informally, locked in their interest rates at the time of application, and many even paid substantial fees to obtain the lock-in. Unfortunately, these lock-ins provided only illusory benefits for many consumers because lenders were unable to process the applications within the lock-in period. Purchase-money borrowers not only experienced nerve-racking delays in reaching closing, but many were forced to accept the higher rates that prevailed after the lock-in period expired.

According to the Washington Post, one victim of the summer's pandemonium was offered three new rates by her lender after the lock-in period expired. The new rates represented a cost of between $11,000 to $18,000 more over the life of the loan than the committed rate. Her upfront point charges were also increased, at an additional cost of between $1,300 to $5,200. (Washington Post, July 5, 1986, E1-2).

Another couple was forced to choose between closing at a higher rate on their new home or calling off the entire sale. It is not hard to guess that they chose the higher rate at the price of an additional $2700 in closing costs and $15,000 in lifetime payments (Ibid.)

Some people may write off the experience of last summer as a fluke. They may argue that a similar drop in rates following a prolonged period of high rates is not likely to recur to cause similar problems of such magnitude. We view this as a dubious proposition.

Some people may say that the severe problems consumers experienced are just an irrevocable fact of life because the industry acted in good faith and was itself victimized by the sudden upsurge in loan applications. We have two responses to this attitude. First, blatant industry wrongdoing should not be a prerequisite to consumer protection initiatives. Second, abuse of the lock-in mechanism does not solely occur as a result of a lender's studied effort to delay the application process. Indeed, the Cannon of Ethics of the Mortgage Bankers Association directs that lenders should not offer lock-in commitments if there is little chance that the loan will close within the lock-in period.[14] Implicit in this ethical guideline is the assumption that lenders have the wherewithal to estimate the processing time required for any particular loan application. This assumption has also been acknowledged by industry members with whom we have spoken. Consequently, it is apparent that to some degree the events of last summer are the fault of an apparently large number of industry members that failed to stop making lock-in commitments when the volume of loan applications indicated that they should.

In the "bad apple" situation, the finite lock-in period allows unscrupulous lenders to intentionally protract the loan application process. In the situation typified by the events of last summer, the finite lock-in period puts all the risk of processing delays on the consumer even though the consumer is not the party capable of anticipating processing time. Lenders can act irresponsibly in offering illusory lock-ins, and emerge from the closing unscathed.

THE SOLUTION

In this area, too, we believe federal legislation is required. Although some states are beginning to address these problems, their powers are limited in at least two ways. First, if their history on state check hold legislation is any guide, it is quite likely that the federal regulators of institutions engaged in mortgage lending would preempt the efforts of the states in this area. Indeed, the FHLBB has already concluded that its effort to address this problem preempts state actions.

Second, to a large extent the mortgage lending industry operates in a national market, which can make state laws difficult to enforce because of jurisdictional problems. A lender may originate a loan on property in any particular state without actually residing in the state. In the case of a successful lawsuit against an unscrupulous out-of-state broker, for example, the plaintiff might have to go to the state where the broker resides to enforce the judgment. The national market also impedes states' administrative enforcement ability because many states rely on their licensing powers to regulate mortgage lenders. If a lender does not reside in the state, the state does not license it. Therefore, the states' coercive and cajoling powers over the lender are lost.

Our recommended federal solution to the problems in this area are relatively simple and straightforward. First, to eliminate the problem to the extent it is a result of faulty communication between the consumer and the lender, disclosure legislation is needed. The disclosures should be make prior to application or at a reasonable time before application fees are assessed. At a minimum, the disclosures should include the following:

1. The lender's estimated loan processing time;
2. The current interest rate and points;
3. A statement of when the lender will "set," or "lock-in" the interest rate and points; and a conspicuous statement that these terms are subject to change until that time. (Lenders should have a corresponding responsibility to secure a written acknowledgment of this disclosure.)

Beyond disclosure, a crucial aspect of any proposed solution is to require lenders to honor lock-in commitments after the lock-in period has expired if the delay is not the fault of the borrower. This substantive provision would eliminate the incentive for "bad apples" to sit on applications to obtain the benefit of an increase in rates. In the case of a processing bottleneck, it would also compel lenders to follow the dictates of the MBA's own Cannon of Ethics. A lender would stop offering upfront lock-in commitments if the increase in applications indicated that it could not process new applications within the time period it wished to be commited to a set rate. This requirement would also encourage efficient processing operations because lenders who offered lock-ins would gain a competitive advantage over those who could not.

Most importantly, under these proposals a buyer would have upfront knowledge of the conditions under which he was proceeding in applying with a particular lender. No longer would he be faced with startling price increases in the pressured atmosphere of the closing room. No longer would he rely on and pay for illusory "lock-in" commitments.

Fixed-Rate Second Mortages and Home Equity Lines of Credit

All of our organizations are seriously concerned about the skyrocketing increase in second mortgage indebtedness. We believe that hearings would be useful to draw attention to the problems inherent in many of the closed and open-end second mortgage loans that are now on the market. Hearings would also help toward the development of some useful legislative solutions. Here we describe some of the abuses in the second mortgage market.

The second mortgage market, of which the home-equity line is a part, has historically posed problems for consumers, who are typically forced to take out a second mortgage because of financial difficulties. According to the National Consumer Law Center, many unwitting borrowers have entered second mortgage contracts with exhorbitant upfront points of between 20 and 30%. In many cases the lender knew, or had reason to know, that the borrower could not make the monthly payments necessary to avoid foreclosure. When foreclosure did occur, the lender still realized a good profit because outlandish points had been charged upfront. Of course, the borrowers lost their homes.

Home equity lines, the open-end version of the second mortgage, have gained increased popularity in the past two years. At the end of 1985, Americans owed some $150 billion in these loans, half of it borrowed in 1985 alone.

The recent change in the tax code promises to keep home equity lines of credit on the forefront of lenders' marketing agenda. Because interest deductions will be limited to payments on loans secured by personal residences, the homeowning public will be particularly susceptible to lenders who are eager to tap into the billions of dollars consumers hold in home equity.

Not surprisingly, the typical home equity loan on today's market has a variable interest rate. In a recent Consumers Union survey of 10 major lenders, each lender's home equity loan program contained a variable interest rate. Not a single product contained either a lifetime or periodic rate cap. One major finance company, Household Finance, offered its equity loans with teaser rates of 8 percent. But that rate only applied for four months, after which the rate jumped to 11.5%. The product was advertised as "loans at prime."

Many of the borrowers who will enter this "new" second mortgage market will not be in the desperate situation historically associated with second mortgage borrowers. But even those who are relatively secure financially can be baffled by the complexity of an adjustable rate instrument. They might not risk their homes, but, without adequate disclosures, they could easily get financially "burned."

And, of course, as these adjustable lines of credit are packaged and marketed, they will not be directed solely to those who are sophisticated enough to consider the tax consequences of their actions. They will also be marketed to the traditional participant in the second mortgage market - the cash-strapped family, which will be more confused and vulnerable than ever.

THE HOME MORTGAGE DISCLOSURE ACT

Permanent Extension

We commend you, Mr. Chairman, for your leadership on the Home Mortgage Disclosure Act, which requires depository institutions to disclose the geographic distribution of their mortgage lending. We know you have supported permanent extension of this important law and we stand ready to help you in any way we can to make HMDA permanent this Congress.

HMDA has been in effect for eleven years. The Act has been an invaluable tool in helping to curb redlining, helping communities monitor mortgage investment and promoting mortgage lending in older urban neighborhoods.

The reductions in federal support for community development programs make HMDA even more essential to neighborhood groups since they must increasingly look for private investment to replace public funds. HMDA imposes no costs on the Government and only de minimus costs on lenders.

Permanent extension would allow community groups to concentrate on rebuilding their neighborhoods instead of investing scarce resources to continually work for extension of a law that has already proven its usefulness.

Expansion of HMDA Coverage

We urge the Committee to expand HMDA to cover the mortgage banking subsidiaries of bank and savings and loan holding companies, and to cover commercial lending. HMDA disclosure by mortgage banking subsidiaries would benefit both companies that originate significant numbers of loans through such subsidiaries and communities because the information generated would provide a more complete picture of lending performance.

At the same time institutions would not be able to hide poor lending performance. This can happen under present law because community groups are unable to evaluate lenders' claims about the performance of their mortgage subsidiaries. Lenders who have a poor record can easily take advantage of that fact.

Disclosure of the geographic distribution of commercial loans would enhance the progress made under present law by encouraging business investment. This type of investment is obviously critical to the vitality of neighborhoods. Commercial loan disclosure could help both to monitor disinvestment and stimulate lending. The expansion of HMDA to cover commercial lending would also respond to the argument that the current law provides a distorted picture of bank performance because the mortgage lending that is disclosed is only a part of total bank lending.

BASIC BANKING SERVICES

Consumers of routine deposit services now pay an estimated $1 billion every month in service fees. As the cost of money has declined sharply in recent months, some banks have cut the interest rates paid to depositors on basic savings accounts -- but fees and the balances required to avoid fees have continued to skyrocket. 40% of all American families have less than $1,000 in total financial assets. These families do not receive "market rates" for their savings. Instead, they pay as much as $15 a month for routine transactions and maintenance of their small savings and checking accounts.

For some, service is not available at any price. Some banks now require customers to have major credit cards in order to open accounts. Bank marketing experts boast of banks that forced thousands of consumers to leave by imposing higher fees and stiff conditions for the maintenance of small accounts. Those who do not have accounts usually find that banks will not cash government benefit checks for them at any price. Parents trying to teach their children the value of thrift have seen those small savings accounts melt away under excessive fees.

As a result, the proportion of American families with no savings or checking account increased by over 10% between 1977 and 1983. This increase is concentrated among families with incomes under $15,000. In 1983, 40% of all families with incomes under $15,000 had no checking accounts. Minority families and young families are also increasingly unlikely to be able to open accounts.

Financial institutions should offer "basic banking" accounts to their customers. A basic account is a non-interest bearing checking account for which no monthly maintenance fee is charged, regardless of the balance in the account. No fees are charged for routine transactions unless those transactions exceed a monthly limit.

Congress should prohibit unnecessary and discriminatory non-fee barriers to deposit services such as credit card requirements. Depository institutions should be required to cash government benefit checks for noncustomers, subject only to identification requirements.

Banks and other financial institutions are chartered to serve a public purpose. They receive enormous public benefits in the form of deposit insurance and access to the discount window. Those public benefits are entirely responsible for over 50 years of consumer confidence in a safe, stable financial system. Those public benefits obligate each financial institution to provide for the basic service needs of the entire community in which it operates.

OVERSIGHT

We believe there is a compelling need for this Committee to look into the performance by the federal banking regulators of their responsibilities under the various consumer protection laws.

Indications we receive from various sources suggest that inadequate resources within the regulatory agencies are being devoted to consumer compliance examinations. At a meeting we all attended last year with officials at the OCC, we were bluntly informed that the staff resources devoted to consumer compliance examination had been been reduced.

This bodes poorly for the effective administration of such laws as the Community Reinvestment Act (CRA), which has never received adequate attention by the regulators. Indeed, in the 9 years since the enactment of the law, the regulators have never taken the steps we regard as basic to its implementation. For example, the law requires the regulators to consider a bank's reinvestment record in making a decision on an application to open a branch or to buy a subsidiary. Several community groups have informed us, however, that no federal regulator has ever contacted them to obtain their evaluation of the performance of banks within their community.

Additionally, although the Act requires banks to help meet the credit needs of their local communities, the regulators have never begun to systematically assess these needs.

THE NONBANK BANK LOOPHOLE

We support legislation to close the so-called "nonbank bank loophole." This loophole undermines the regulatory structure of the banking system. A company that owns "non-bank" banks rather than banks escapes Federal Reserve supervision under the Bank Holding Company Act. This supervision relates to the financial condition of the entire holding company. For example, companies owning nonbank banks are exempt from 12 U.S.C. 1844, which allows the FRB to examine the records of the entire BHC for safety and soundness purposes. Nonbank banks are also exempt from 12 U.S.C.§371c, which restricts the dealings between a bank and its BHC affiliates. These restrictions safeguard the safety and soundness of the entire banking system. They limit the affiliate interactions that could pose unwise conflicts of interest problems that work to the financial disadvantage of the banks within the holding company structure.

The fact that these holding companies escape the Bank Holding Company Act means, in more general terms, that there is a lack of effective policy control over the nation's banking structure. For example, through nonbank banks, BHC'c can

circumvent the restrictions of the Glass-Steagall Act. The nonbank bank loophole could also undermine FSLIC recapitalization legislation and the purpose of the emergency interstate acquisition authority. This is because few banks or savings and loans are likely to be interested in purchasing a failing institution if, for less money, they can enter the same market through a nonbank bank.

EXPANSION OF EMERGENCY INTERSTATE BANK ACQUISITION AUTHORITY: THE REGULATORS' BILL

Expansion of the bank regulators' authority to order "emergency" interstate acquisitions is a solution in search of a problem. State interstate acquisition laws and existing emergency authority already provide adequate tools to allow acquisition of failed or failing banks on reasonable terms. The regulators' proposals provide substantial benefits to acquiring banks in the form of low-cost entry into new markets, while undermining local control over banking. These proposals provide no compensating assurances that consumer, neighborhood and community needs will be considered, let alone met.

The emergency acquisition authority requested by the regulators in 1986 would not have allowed the acquisition of a single bank liquidated in 1985. Today, newly passed interstate acquisition laws cover parts of the country identified by the regulatory agencies in 1986 as posing potential problems. Additional, federal authority to break down the few remaining barriers to interstate expansion appears unnecessary.

The benefits of emergency interstate acquisitions to acquiring banks are large, and the costs of emergency acquisitions to acquiring banks are vastly overstated. Acquiring banks gain entrance into new markets and the FDIC is left holding the bad loans and facing the problems which caused the failure.

Potential acquirers should be required to bid against each other for such an opportunity. Current law and the regulators' proposal include a bidding process, but that process does not go far enough. If an emergency acquisition bill is passed, it should include consideration of acquirers' competing commitments to, and records of, meeting the credit and deposit needs of consumers and neighborhoods, with particular emphasis on the needs of low-and moderate-income consumers and neighborhoods.

EXPANDED BANK POWERS

There are three basic dangers to consumers in proposals to allow federally insured depository institutions to offer services not now permitted by law. Each of these concerns must be evaluated in the light of each proposed expansion of authority.

First, no expansion of powers should be permitted that directly or indirectly threatens the stability of the deposit insurance system or the safety and soundness of any institution. Consumer confidence in federally insured depository institutions rests completely on deposit insurance. Even the implication that that system supports unrelated services must be avoided at all costs. If deposit insurance is seen as backing other activities, it will lose its special character and consumer confidence in insured institutions will suffer.

Second, restrictions must be developed that clearly prohibit tying in the broadest sense. Consumers should not be left with even the implication that their access to basic financial services depends in any way on their purchase of other services.

Finally, federally insured depository institutions have, in exchange for that insurance and for other public benefits, responsibilities to the communities in which they operate. We believe these responsibilities include, at a minimum, provision of basic deposit and credit services accessible to the community at large. Permitting banks to offer additional services risks dilution of their commitment to offer basic services to their communities. Where appropriate, new powers should be structured to require that they are directed at a market that includes the average household. In any event, expanded powers should be allowed only to those institutions which demonstrate, on a continuing basis, an exemplary record of meeting the basic credit and deposit needs of the communities they are chartered to serve.

FOOTNOTES

1. "Still Held Up at the Bank: The Second National Study of Check Holds," U.S. Public Interest Research Group. May, 1986.

2. "Held up at the Bank: A Study of Check Hold Policies Across the Nation," U.S. Public Interest Research Group. April, 1985.

3. "Checking on Accounts: A Survey of Fees, Charges and Check Holds imposed by Financial Institutions in the Washington, D.C. Metropolitan Area," Public Citizen. March, 1985.

4. Statement of Preston Martin, Former Vice Chairman of the Federal Reserve Board, Hearings on the Expedited Funds Availability Act before the Subcommittee on Financial Insitutions of the House Committee on Banking, Finance and Urban Affairs, 98th Cong., 2d. Sess., April 4, 1984, p. 213. (Hereinafter referred to as 1984 House Hearings).

5. "Bank Fees on Consumer Accounts," Consumer Federation of America. June, 1986.

6. House Banking Committee Report on The Expedited Funds Availability Act, November 26, 1985. 99th Cong., 1st Sess., Report #99-404. Page 12.

7. Steven Weschler, "Delayed Funds Availability," 35 Syracuse Law Review 1117, 1158 (1984).

8. Delayed Funds Availability Task Force, "Final Report and Recommendations," February, 1979. Page 10.

9. Statement of Preston Martin, Former Vice Chairman of the Federal Reserve Board, Hearings on the Expedited Funds Availability Act before the Subcommittee on Financial Insitutions of the House Committee on Banking, Finance and Urban Affairs, 99th Cong., 1st Sess., Oct. 10, 1985. Page 211.

10. Statement of U.S. League of Savings Institutions, Hearings on the Fair Deposit Availability Act before the Subcommittee on Consumer Affairs of the Senate Banking Committee, September 28, 1983 at 20.

11. 1984 House Hearings at 193.

12. Id.

13. "The Impact of Exception Items on the Check Collection System," Bank Administration Institute, 1974. The report also found that the total estimated loss for banks was only $5 million.

14. Cannon 10 states: "Members shall not quote to a prospective borrower interest rates or other loan items that are not likely of realization."

Ms. MEIER. No, as long as the delegating authority set very clear parameters under which the Federal Reserve Board was to proceed.

The CHAIRMAN. Do you agree, Mr. Fox?

Mr. FOX. Yes. We would prefer that Congress set out the schedule in some detail, largely because the Federal Reserve history of inaction leaves us very reluctant to rely on the Fed to do a proper job. However, if Congress were to set an outside limit, say that after a period of a few years no check may be held for more than 4 days and then give very straightforward criteria to the Fed on how to set up a schedule that required further holds for certain circumstances, then that's something that could be workable and may be more acceptable to others.

The CHAIRMAN. I have one other question for the three of you. My time is almost up but let me ask you this.

In your joint statement you say that from the standpoint of consumer interest the nonbank bank loophole should be closed and you cite a variety of financial risks and related reasons.

Your views would be of great use to us in evaluating the statements of other witnesses who claim that closing the loophole would not be good for consumers. That's what they stress. They always say it's a consumer issue here; that they want nonbank banks because that's going to help consumers.

Well, you represent the consumers directly. You've taken a contrary view on the nonbank bank. Could you be more specific as to why you feel the nonbank bank loophole should be closed with respect to the interest of consumers?

Mr. FOX. The issue is often made into a consumer issue and I think frankly that's largely a political effort by those who own nonbank banks to try to justify that.

If increased competition by creating new banks were the only issue, then there wouldn't be any disagreement. But of course the banking system isn't one that has ever—at least in the last 50 years—operated on the principle that anyone and everyone should be able to own a bank. There are a variety of very specific Federal benefits that accrue to those who do own banks—access to the payment system, Federal insurance and so on. And those create both some obligations on the industry to meet basic consumer and community needs and they create the need for regulatory structure to protect the public interest.

I want to point out that few, if any, of the existing nonbank banks are what could be called and are called by some in the banking industry—or the nonbank banking industry—consumer banks. Most of them do not specifically direct their services at improved consumer services.

The argument is made to us frequently that a species of a bank called the consumer bank ought to be established that would provide faster availability of checks and better disclosures and so on. It's our position that those are obligations of every bank, every financial institution, and we would very much object to setting up a two-class banking system where there are consumer banks that may be limited in number and limited in scope that provide certain disclosures to consumers, and thereby directly or indirectly relieve other banks that are more accessible to consumers of the obligation to meet basic consumer needs.

Second, I think there are some very obvious regulatory problems that need to be addressed. Our experience in dealing with the Federal regulatory agencies is that they claim they do not have the resources today to adequately enforce the Community Reinvestment Act or consumer compliance exams.

We think if that's the case, Congress' first priority ought to be to be sure that existing law that protects consumers is enforced and enforced well, existing law that benefits communities is enforced, before adding what is going to be a tremendous and a new type of regulatory burden to the regulatory agencies.

The CHAIRMAN. Thank you very much. I take it, Ms. Livingston and Ms. Meier, that you agree with Mr. Fox?

Ms. LIVINGSTON. Yes.

Ms. MEIER. That's right.

The CHAIRMAN. Well, I want to thank you. Senator Chafee, if you would like to defer to Senator Graham that's fine, but you're due next because we go back and forth by party.

Senator CHAFEE. Well, why doesn't Senator Graham go ahead and I apologize for being late.

The CHAIRMAN. Senator Graham, go ahead.

Senator GRAHAM. Advocacy of a law or regulatory change carries with it the premise that the marketplace undirected is not meeting the need that you feel should be achieved.

EVALUATION OF THE MARKETPLACE

Let me ask for your evaluation of how well the marketplace is working in three consumer-related issues: one, the check hold question. Are there, for instance, banks which are advertising or in other ways using as an inducement for depositors an expedited processing of checks? Two, is the question of credit card interest. I'm sorry I did not hear the first part of your testimony. I don't know if you touched on that. That came up yesterday as a consumer issue. And three, it's my understanding that about 20 to 25 percent of the families in America do not have bank accounts and that's one of the arguments for the nonbank bank or for the establishment of a new class of consumer banks.

What is your assessment of why the marketplace is not operating to provide banking services for that proportion of American families?

Mr. FOX. First of all, with respect to check holds, I don't think any of us are aware of a single financial institution in the country that is advertising that it provides better availability to depositors' checks. I have never seen that in an advertisement. That may be regarded by some banks as an element of an overall friendly service-better service sort of advertisement, but I have never seen that.

What we find instead is that within particular communities there isn't very great competition and what variances there are on funds availability often are variances from community to community. I am told in fact that Monday's Miami Herald will have a survey of the Miami area financial institutions which will show some of the longest hold periods in the country in existence in South Florida. That confirms surveys that some of our organizations have conducted in South Florida periodically over the past few years.

With respect to credit card interest, there is not competition in credit card pricing because there's not adequate information available to consumers to evaluate credit card pricing. There's not adequate information on a couple of grounds.

One is that the offerers of credit cards don't do very much to provide that information. Second, to the extent information is provided, whether it's interest rate or annual fees, it's difficult to find and it's often very difficult for consumers to use in that it can't be translated very easily into a dollars and cents comparison between cards. The market in credit cards is beginning to respond a little bit to concerns about pricing we believe, but that's as much due to efforts of the news media and consumer organizations—probably more due to those efforts than it is due to efforts by offerers of credit cards to publicize lower cost cards.

It's our analysis that of those consumers who do not have checking accounts, probably about half would not want to have accounts in any event. But the other half, the other 10 to 12 percent—and I would agree with the figure you cited—do not have access and are losing access in some cases to accounts because of high fee and minimum balance requirements and those fee and minimum balance requirements are escalating sharply and have continued to escalate sharply in recent years.

SHARP INCREASE OF FEES CHARGED CONSUMERS

Our organization, in cooperation with a number of our member groups, conducts an annual survey of bank fees around the country. We've been doing this now for 3 years, 1984 through 1986, during a period of relatively low inflation, and we have seen very, very sharp increases in fees that are charged to consumers. And because those fees are most commonly tied to balance requirements, it's very clear that those fees are most adversely affecting consumers with small amounts of money.

I don't see any evidence that those who are proposing to implement nonbank banks are going to target the sector of the market that most needs low cost accounts. There may be some way to require them to do that. If it's good for them to do, we would just as soon Congress require all of the banking industry to provide access to that segment of the market because we already have in place thousands and thousands of banks and thrifts in neighborhoods across the country. That seems like an easier solution to the problem of access to accounts than to rely on the establishment of a new class of institutions which may or may not end up meeting that need.

Ms. Meier. Senator, just to add briefly if there's any time, is there?

The Chairman. What's that?

Ms. Meier. Is there any time to make an addition to that statement?

The Chairman. Well, Senator Chafee is going to be the next questioner. If you have something you would like to add very briefly I think it would be all right.

Senator CHAFEE. Go ahead.

Ms. MEIER. Only on the check hold issue, some have raised the possibility of limiting any check hold legislation to merely a disclosure law. One, we feel that it is not doing much of a service to consumers if you're only going to be disclosing what we consider to be an unfair practice anyway.

Plus, I think it's important to realize that the availability schedule of any particular institution is only one of very many other important considerations that any individual consumer has to take into account in looking for a checking account and so that one factor cannot be the basis upon which a consumer chooses an institution. So there are great limits on the ability of the market and competition to remedy the problem.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

First, I'm very interested in the whole check holding business. Like everyone else, I have had experiences caused from children away at college and you send them a check and it doesn't seem to do them any good for about 5 or 7 days.

So what is your specific recommendation, Mr. Fox, on this? What legislation do you espouse?

Mr. Fox. We believe that Congress needs to establish a system whereby within a very short period of time consumers are required to have access to checks in no more than 4 days, with a tiering below that 4 days period based largely on geography, whether a check is local or not, and with a number of fairly carefully defined exceptions that allow institutions to hold checks longer in circumstances such as the establishment of a new account where there is a risk that's been clearly defined and that everyone can observe is a risk.

Senator CHAFEE. I'm not familiar with the House legislation. Was that what the House legislation was, roughly what you say?

Mr. Fox. Roughly that, yes.

Senator CHAFEE. Do you agree with that, Ms. Livingston?

Ms. LIVINGSTON. Yes, I do. The kind of scheme that Mr. Fox is describing is also the kind of scheme that's been adopted by States where you have a mandatory——

Senator CHAFEE. Why don't we call it a plan instead of scheme?

Ms. LIVINGSTON. OK, plan. The basic plan is that there is a mandatory availability schedule where the actual days are set.

Senator CHAFEE. Based on geography? There certainly should be some geographical spread.

Ms. LIVINGSTON. Different States have done it differently. For instance, Massachusetts looked at when the bank of deposit gets provisional credit for a check and they did that because most checks are good and then they created exceptions for situations where a bank could be at risk. For instance, a new account holder.

Senator CHAFEE. A new account, like Mr. Fox described?

Ms. LIVINGSTON. Exactly.

Senator CHAFEE. Let me ask you another question. Mr. Fox—and I apologize for being late. I didn't hear all the testimony. But it seemed to me you indicated that the nonbank banks are not providing what you would call consumer services. Yet the nonbank banks are providing a service to an incredible number of people, which is indicated by the fact that the volume financially and transactions are so substantial that the nonbank banks are handling, so we ask ourselves, if we're trying to do something for the public, are we handicapping the public if we restrict the nonbank bank?

Just take in checking accounts that Merrill Lynch has, for example.

MOST NONBANK BANKS DON'T PROVIDE BASIC CONSUMER SERVICES

Mr. Fox. My understanding is that most of the nonbank banks that have been chartered—first of all, many are not in operation, but most that are in operation are not providing what we consider basic consumer services. They are not providing the ordinary checking account and savings. They are instead providing special services to other banks. In many cases, they are simply ways to provide credit card operations. The nonbank banks are special purpose banks and the special purpose they serve is rarely specifically the sort of consumer service that's usually promoted as a benefit of the banks.

If the goal is to have more banks and thereby to have more competition, certainly that's served by removing any restrictions on ownership of banks. But that has to be weighed against a variety of other concerns and those other concerns are things that we as consumer advocates care about as deeply, in some circumstances even more deeply, than creating additional competition.

There are a lot of competitors out there. I don't know why many of them aren't doing the job they are supposed to do. Adding a few more may not be the solution to providing those sorts of services to communities.

An example, one of the concerns many of the groups we work with have is that in large areas in central cities there are just no bank branches to be had any more. Banks have pulled out of inner cities. I doubt that nonbank banks are going to provide that sort of service to neighborhoods that now do not have services. I think we're going to see nonbank banks in shopping malls in the suburbs, not in the inner cities.

Senator CHAFEE. Well, I'm not going to dispute that. It just seems to me that a service is being provided that millions of people are taking advantage of. Now they are doing it because presumably it's better than they could get from a bank.

What do you say to that, Ms. Meier?

Ms. MEIER. Well, I think there are several responses. I tend to agree with Alan that nonbank banks that we have looked at aren't gearing themselves to the population that we are most concerned about in the financial services area, those who are being hit with increasing service charges and basically implicitly being told that, "We don't want your business."

I think another thing that isn't considered in terms of consumer interest against nonbank banks is consumer interest in a basically healthy and sound financial system. There are great constraints on the ability of the regulators to make sure that companies owning nonbank banks are sufficiently sound that there will be no potential financial problems within the nonbank banking subsidiary itself.

Senator CHAFEE. Well, thank you. My time is up. I appreciate it. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

May I ask the panel a couple questions. There are roughly 14,500 commercial banks in America today and if you want legislation would you bring all these banks together on this check holding and the restrictions, or would you lump smaller banks in one category and larger banks in another category?

Mr. FOX. I think if there's some evidence presented that indicates that smaller banks, or thrifts, or credit unions, or some other category of banks take longer necessarily by the way the system operates to process checks, then it would be appropriate to differentiate on that basis. But that has to be on the basis of some evidence that's clear.

MAIN FACTOR OF AVAILABILITY IS GEOGRAPHICAL

I'm not sure that that evidence has been presented. It's our experience that the check processing system works very, very quickly for all institutions, whether they are small banks or large banks, that the main factors that tend to affect availability are geography and probably even more than geography what I guess I would call the remoteness of institutions. So there are some institutions in small towns in your State that are far away from major metropolitan areas and there the Federal Reserve has discovered that there is some extra time needed and that's reflected in provisional credit schedules which ought to be the basis of any differentiation.

Senator HECHT. And I don't have the statistics on top of my head, but a bank of 100 million footings or less would have a very, very difficult time complying with set standards on check processing.

Mr. FOX. They apparently do not have any difficulty handling the availability schedules that are in operation today. We went on a visit to the Baltimore check clearing center of the Richmond branch of the Fed and looked at the availability schedule that is used there. And there's no figure there that's longer than 2 days for provisional credit. You can get provisional credit on a check deposited in the Baltimore-Washington area in 1 day and Los Angeles, and an extra day, 2 days, in smaller towns in the West where the access to the major airports may take an extra day.

Senator HECHT. I want to see evidence of that. As far as new accounts, that's where banks take their biggest hit, on new accounts. I mean, that's where you're really hit as far as your losses and that's very, very difficult to process a check in a certain amount of time.

Mr. FOX. That's why we believe that new accounts ought not to be subjected to short-hold periods. People we have spoken with who are involved in law enforcement who deal with bad check problems indicate that new accounts are a serious problem and we certainly support exempting new accounts from any availability schedule.

Senator **Hecht**. I missed part of the testimony for which I apologize. What amount of time are you proposing to have checks clear?

Mr. **Fox**. Our position would be a maximum of 4 intervening days, which because of weekends would amount to a full week, with shorter periods scaled down either through legislation or by the Fed based on some of the criteria we have been discussing.

Ms. **Meier**. Senator, what that time period reflects is the time needed for a bank of deposit to get credit to use the funds represented by the check that's deposited. It doesn't incorporate the timing for the check to come back because even long hold periods can pass before a return process brings a check back to the bank of deposit.

So I think that's very important for everyone to understand, that our scheme is premised on the length of time needed for the bank to actually get to use the funds itself.

Ms. **Livingston**. Just to add to that a little bit, that credit scheme is basically a 1-to-3 day time period before a bank gets credit for the check that a consumer deposits and that 1 to 3 days is true as far as we know for almost all institutions. The Federal Reserve figures show that in 99 percent of the cases banks get credit for the check in 1 to 2 business days, and that the rest clear in 3 days.

Senator **Hecht**. I'll have to check those statistics with the representatives of the smaller banks, but I think there's a lot more to it. I think you're making a very simplistic statement and it's not that easy because banks have tremendous personnel problems. I think bank turnover is probably one of the largest of any industry. So I would check those figures. But my time is up. Thank you.

The **Chairman**. Thank you very much, Senator Hecht.

Senator Heinz.

STATEMENT OF SENATOR JOHN HEINZ

Senator **Heinz**. Mr. Chairman, thank you.

Mr. Chairman, in concluding this round of hearings, I have been impressed and concerned by the testimony and answers provided by the witnesses. More importantly, several responses have raised additional questions which, in my mind, must be resolved before we can proceed.

Chairman Volcker indicated that certain issues were matters of great urgency and should be considered simultaneously. I agree with him on four out of five, at least at this point. The FSLIC recapitalization, regulators provisions, nonbank bank loophole, and check hold legislation have been on our agenda and debated long enough for us to come to some consensus. However, although the issue of further deregulation and partial repeal of Glass-Steagall has been debated, it begs the broader question of whether the existing banking laws are no longer necessary or serve no effective public policy today.

Moreover, it was troubling to hear Mr. Volcker say: That the Fed is ready to act if Congress is not, to expand bank powers to include certain underwriting activities, a theme mirrored in the testimony of the other two bank regulators regarding the chartering and insuring of nonbank banks.

With all due respect to these gentlemen, I believe that it is the Congress' function to provide the statutory framework which, in turn, is to be implemented by the regulators in accordance with the letter and intent of the law. In some instances, where the regulators are bound to interpret the law because of judicial decisions, obviously they have no choice. However, it is Congress' responsibility to set policy, not the regulators prerogative to reinterpret the law.

Mr. Chairman, it may well be that this committee and the Congress will decide that Glass-Steagall or the Bank Holding Company Act no longer serve either the financial services system or the public. However, it would be irresponsible for us to approach this on a piecemeal basis without first clarifying the inconsistencies. When that is done, we can then review the entire statutory structure, including the deposit insurance system and the pricing of risk of these new activities. But first and foremost, it is important that the FSLIC recapitalization legislation be passed as soon as possible because we won't have a deposit insurance system to assess if the FSLIC is not first stabilized.

Mr. Chairman, the reason for our reservations about including the four proposed securities activities for banks in the legislation so urgently driven by the need to recapitalize the FSLIC is that they cannot be insulated from the larger debate on the entire set of Glass-Steagall issues.

Second, let me apologize to the witnesses that you did a better job of beating the traffic and the snow this morning than I did. We appreciate your being here. I know you have been over a lot of questions on check hold.

I understand someone asked you earlier your position on the nonbank bank issue and I gather your answer was that you on balance felt that the nonbank bank loophole should be closed. Is that correct, Mr. Fox?

Mr. Fox. That's correct.

Ms. Livingston. Yes.

Ms. Meier. That's right.

Senator Heinz. Senator Proxmire has been quite forthright in wanting to close that loophole, as I have, and this committee reported legislation to do so about 2½ years ago and it's my hope that we can move ahead with the FSLIC recapitalization and close the nonbank bank loophole.

There was a third thing I would like to add to that. It would be closing another loophole known as the South Dakota loophole. Let me ask you about that particular loophole.

That's the process by which a State regulated bank may in another State engage in selling insurance through a subsidiary located in the first State.

What points of view, if any—and I know you didn't particularly testify on this—how do you feel about banks selling insurance in other States and should we close the South Dakota loophole or not? Does anyone want to answer that?

Mr. Fox. That's not something that we have looked at closely.

Senator Heinz. I don't want you to take a position on something you're not prepared to, and I see that nobody is jumping up and down, so let me move on to the next subject.

There's going to be an attempt I assume to encourage the committee to adopt a number of additional securities powers for banks, mutual fund underwriting, mortgage-backed securities, municipal revenue bonds, to name three.

What is the position of each of your groups on additional security underwriting and/or dealing powers in these types of instruments for banks? Mr. Fox, do you have a position on that?

Mr. Fox. I guess our position is that in principle there is no particular problem with some of these powers, but we have some practical problems that affect consumers that we think need to be dealt with. I will single out one that I think is most important to us.

Banks are chartered to provide services to the community and we believe that that means that they are required and ought to provide service in a broad sense that's available to the entire community in which they operate. That's something that is getting lost by the wayside quite often and the result is that costs to typical consumers of small basic transaction accounts have gone out of sight.

Our concern simply is if banks are permitted powers beyond what they have now they will continue to lose sight of what their basic function is and what their basic responsibilities are to the communities in which they operate.

We believe that Congress ought to structure the provision of additional powers so that they are not regarded as a right due to every bank that exists in the country but are a privilege accorded to those banks that can demonstrate on a continuing basis that they are adequately meeting the basic credit and deposit needs of the communities they are chartered to serve.

Senator Heinz. Is there any—I've got some followup questions I want to ask if there's time. Is there any additional or different points of view from what was just described?

Ms. Meier. No. Our positions are the same on that and we elaborated on them more in our written statement.

Senator Heinz. Now one of the principal arguments—not the only argument—that the banks should engage in these other securities activities is that there is not enough competition. Senator Garn, the former chairman of this committee, was a mayor of Salt Lake City and he's often been quoted as saying, "Well, we really needed more people out there selling our municipal revenue bonds."

Of course, for the most part the typical consumer doesn't invest in municipal revenue bonds. He might, however, invest in a mutual fund. My question is: Is there any evidence that there is now insufficient competition among people out there selling mutual funds, for example? As consumers and representatives of consumers, do you see any pressing consumer need to have more people selling mutual funds or you don't have much feel one way or the other?

Mr. Fox. I can't say that it's anything we have examined on a scientific basis at all. So I guess we don't have that information.

Senator Heinz. So there's no lack of competition apparent.

Mr. Fox. When I open the newspaper I certainly see enough advertisements for mutual funds to bewilder me into wondering what the right choice would be, but that's only a very crude measure of what competition is.

Ms. MEIER. Senator, how my organization has approached the issue is, is there any inherent problem to consumers posed? Given the potential for increasing competition, regardless of the details of the particular market involved, unless there are any problems, we would support the allowance of the potential for increasing competition.

Senator HEINZ. All right. Thank you very much.

The CHAIRMAN. Thank you, Senator Heinz.

Thank you very much, members of the panel. This has been an excellent panel.

Our next panel is Mr. Bob Evans, president of the American Financial Services Association; Mr. Alan Heuer, who is chairman of the government relations committee of the Consumer Bankers Association; and Mr. John Motley, director of Federal legislation for the National Federation of Independent Business.

Is Mr. Motley here? Is anybody here to speak for Mr. Motley? If not, perhaps he will show up before we are finished. If not, we will have his statement printed in the record.

Gentlemen, we are delighted to have you. Our first witness will be Mr. Evans, president of the American Financial Services Association.

STATEMENT OF ROBERT B. EVANS, PRESIDENT, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. EVANS. Good morning, Mr. Chairman.

I am Robert B. Evans, president of the American Financial Services Association [AFSA] and I'm standing in for our announced witness this morning because Mr. Ford, who is vice chairman of Security Pacific Corp. was cut short in Kansas City yesterday when they canceled the remainder of his flight and could not get into Washington. I'm sorry that he can't testify because he would have brought with him a unique perspective, I think, Mr. Chairman, as one who is not only vice chairman of a very large bank holding company but one who oversees the operation of their nonbank financial services and has a view I think that would have helped the panel. However, I will try to fill in for him.

Like you, members of our association are trying to cope with many of the rapid changes which have taken place in the financial services marketplace in recent years. Unfortunately, though, most reports of market change are accompanied by vague and disparaging discussion of how some regulatory loophole is behind the change.

Recently, Mr. Chairman, it seems that we hear about nothing but loopholes—the nonbank bank loophole, the nonthrift thrift loophole, the Delaware, South Dakota, and District of Columbia loopholes—and now, most recently, the "substantially engaged" loophole. Soon I'm sure we will be hearing about the New York and the 5,000 person town loopholes as well as others not yet even named.

We think, however, it is more appropriate and accurate to view these changes as responses to evolving consumer needs rather than as loopholes.

Framing the policy debate in terms of loopholes is to treat regulatory shortcomings in an evolving marketplace as positive factors rather than as impediments to competition, as they really are.

Since AFSA has submitted an extensive written statement for the record, I'd like to make three major points before the committee.

CONSUMERS ARE BENEFITED BY DIVERSIFIED FIRMS

First, let me suggest that, contrary to remarks you heard earlier today, consumers are being benefited by diversified firms entry into the financial services market. For instance, joint ventures between different industries have brought financial services to consumers conveniently and at lower cost.

Ford Motor Co. savings and loan subsidiary, First Nationwide, is offering consumer financial services in K Mart stores. This program is being expanded to 150 stores around the country. Are consumers being hurt by this? On the contrary, at K Mart they are getting 30 to 40 to 50 basis points higher return on their CD's than at their competition around the same locality.

Security Pacific has a similar joint venture with JC Penney, and certainly Sears financial centers and credit cards bring to middle income Americans an array of financial services they previously may not have had offered to them or had not been made accessible to them.

Many of the Nation's most competitive markets—for example, California and New York—small banks compete with some of the largest banks in the country by finding profitable niches in the marketplace. Size alone is not the determinant of success. The companies that succeed are those that are well-managed and offer value to the customers.

In New York State this was brought about several years ago when New York City banks attempting to expand upstate found that consumers preferred doing business with their local financial institution.

Now my second point is that there are indeed serious problems in the Nation's financial system, but these problems stem not from financial deregulation but rather from the regulatory restrictions still remaining that stifle innovation and diversification.

For example, much of the savings and loan industry, limited by Government policy to overspecialized lending, is under water. On Wednesday, you heard that 347 savings and loans were losing $6 million a day. That's about $2.25 billion a year and it makes you wonder whether any plan of recapitalization can succeed unless these losing associations are actually put out of business and I have not yet seen that proposed.

Restrictions on geographic expansion have also contributed to many of the bank and savings and loan failures we see today. This fact is increasingly being recognized by community leaders in States heavily dependent on agriculture and energy.

In Iowa just this month a group of business leaders and farmers began pushing for interstate banking. Why? As the group said:

> Interstate banking is necessary because the agriculture and the business climate in Iowa is floundering because of the lack of competition within the State's archaic banking system.

As you know, that's a unit banking State.

My third point is that our Nation's financial institutions are unable to compete in the global marketplace because of current restrictions. Foreign banks, unfettered by similar restrictions, have established beachheads in America. I'm not worried about our will to compete with them or our competence to do so. I am concerned about our ability to compete as equals.

For these reasons, this is not time to turn back the clock with restrictive legislation. I see my time is up, Mr. Chairman. I'll just urge that we eliminate restrictions on competition and accord all financial service providers an equal opportunity to serve the full range of financial needs. Thank you.

[The complete prepared statement of Mr. William F. Ford follows:]

Statement of

William F. Ford

Chairman

AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. Chairman, Members of the Committee, I am William F. Ford, Vice Chairman of Security Pacific Corporation and Chairman of the Board of the American Financial Services Association (AFSA).*

I appreciate the opportunity to appear before you today to present the views of AFSA on the important issues of financial regulatory reform you have raised. I commend you for taking a fresh look at these issues so early in the new Congress. I would like, first, to discuss briefly some general principles that should characterize regulatory reform and then, in that context, to visit the important specific issues you have raised, especially the question of consumer banks.

FINANCIAL REFORM

Mr. Chairman, I know you are well aware of the tremendous changes that have been taking place in financial markets and institutions in this country. At first glance many of the changes appear surprising, even bewildering: insurance companies are in the banking business, investment banks are placing securities based on auto loan and credit card receivables, automobile finance companies are in the home loan business, and retailers are offering an array of consumer financial products. Hardly a day goes by, it seems, without report of some new, even startling, development.

Unfortunately, however, all too often reports of market change are accompanied by vague but pejorative discussion of how some regulatory "loophole" is behind the change. But focusing on so-called "loopholes" or on the closing of "loopholes" in an antiquated and outdated regulatory structure misses the point of what is happening in financial markets and institutions today. More basic forces are involved, including important economic and technological changes that are rendering obsolete many of the old ways of doing things.

Mr. Chairman, I know you realize that fundamental financial regulatory reform is a tall order. Tradition and inertia stand in its way, not to mention the influence of special interests. Nevertheless, this Committee under Senator Garn has held extensive hearings on reform during the past few years, and many good ideas have surfaced. Among them are complex suggestions in technical areas such as deposit insurance reform. In such a complex and technical environment it is easy to lose sight of the underlying principles that should guide reform. Before proceeding to the specific issues of today's hearing, I would like to comment on three of these general principles:

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*AFSA is the nation's largest trade association representing nonbank providers of consumer financial services. Organized in 1916, AFSA represents over 580 companies operating more than 11,000 offices serving the public throughout the country. AFSA membership is highly diversified, ranging from independently-owned consumer finance offices to national delivery companies engaged in unsecured direct lending, second mortgage lending, consumer banking, industrial banking and the financing of the sale of durable goods.

- Competition should be an important element of public policy.
- Regulation should be directed to specific problems in need of correction.
- Government protections should be eliminated where they are not necessary.

Competition

Benefits of Competition. Common intuition, as well as history and theoretical economics, suggest that competition is good for the public. Although the benefits of competition are generally well understood, they are worthy of constant repetition.

First, competition assures that products and services are available to those who demand them at minimum production cost. This is, of course, the concept of efficiency. Simply stated, competition causes resources to be allocated to their most productive uses with minimum loss of resources along the way. Competition assures that firms providing the wrong products or products that are too costly because of inefficiencies will lose ground in the marketplace.

Second, competition reduces potential conflicts of interest and concentrations of power that, along with higher prices, are the hallmarks of uncompetitive markets. Put another way, competition assures that firms taking advantage of customers will also lose ground in the marketplace.

To gain these benefits, free entry into markets by potential competitors is an important prerequisite. Even where some degree of competition already exists, full benefits might not be realized if market participants are not kept on their toes by the potential for new entry. As soon as substantial barriers to entry are put in place, the competitiveness of markets begins to deteriorate and the resultant benefits to customers to decline. And as competitiveness ebbs, the quality of service declines, the price rises or both.

Competitive Success Does Not Depend on Size. In this context, it is important to note that in consumer financial markets where AFSA directs its primary attention, competitive success is independent of firm size. Academic and regulatory agency research suggests that neither large nor small firms have an inherent cost advantage. These findings are confirmed by casual observation that shows many small banks, finance companies, savings and loans, and credit unions are active and successful in the marketplace alongside the big ones. Consequently, permitted entry of large institutions, even out-of-state or foreign ones, will not drive out small organizations unless the large ones are better managed and serve the public better.

Likewise, entry of small institutions will not drive out the large ones unless the small ones serve the public better. The analogy to retailing is obvious. In retail merchandising we see both large and small stores are found in the same marketplace and often side by side in the same shopping malls. Neither large nor small size is a guarantee of success. The same has been true in banking. In my state of California many smaller independent banks have prospered alongside larger banks such as my own, Security Pacific. Both large and small banks serve the public better because competition keeps them on their toes.

Regulation of Specific Problems

After promotion of competition, a second guiding principle of regulatory reform should be direction of regulation toward specific problems rather than enactment of a stifling framework with unintended, and possible unfortunate, side effects. Many examples might be cited, but already-mentioned deposit insurance offers a good one.

It has become apparent that underpriced or mispriced federal deposit insurance has encouraged some institutions to take on excessive risk, jeopardizing the deposit insurance system itself. In response some observers, including some regulators, propose heavy-handed regulation of activities and entry that ultimately could stifle innovation and financial flows. Better, it seems, would be adopting the principle of directing regulation to specific problems by improving the pricing mechanism for deposit insurance. While this solution might be technically complicated, it has the obvious advantage of not eliminating innovation and competition that is beneficial to the public.

As another example, some observers contend that permitting greater bank participation in securities markets would produce conflicts of interest. Whether or not this is the case, it seems better to approach the conflicts of interest issue directly rather than by automatically eliminating potential banking competitors from the marketplace. Again, directly addressing the potential problem area might seem complicated, but the public benefits from enhanced competition make it worth the effort.

Eliminating Unneeded Institutional Protectionism

A third principle that should underlie regulatory reform is elimination of institutional protectionism. Some consumers may require government protections, but institutions typically do not.

Adherence to this principle requires careful examination of the effects of regulations to identify unintended protectionist results. Some examples are obvious, most importantly entry restrictions which, in effect, employ the power of government to protect firms already in the market. Less obvious are government reporting and even consumer protection rules that are especially burdensome to those smaller firms without extensive accounting, computer, and legal staffs. Such rules potentially advantage large firms. In general, the principle should be careful review of all regulations with the goal of eliminating any protectionism. We commend the Committee for being aware of the problems of smaller institutions and urge continued attention to all potential sources of government protectionism.

CONSUMER BANKS

Mr. Chairman, keeping these general principles of regulatory reform in mind, let me now turn my attention to the specific issues you have raised, particularly the issue of consumer banks.

Historically, consumer financial services have been offered by many types of companies, which often have specialized in particular product or geographic markets. Today, technological and communications improvements are lowering the costs of producers. These changes are permitting companies to offer new combinations of products, to extend the scope of their current markets, and to enter new product and geographic markets. Such changes should improve the quality of products and services, and make the markets more competitive to the benefit of the public.

In consumer financial markets an important corollary of technological change is the fusing of asset and liability services. Whereas at one time consumer credit products (consumer liabilities) were largely distinct from products like deposits (consumer assets), this is no longer the case. Today, newer credit products like revolving credit and credit cards, together with new asset products like automated tellers, debit cards and electronic transfers, are increasingly bringing credit and asset services together. In the future, joint provision of credit and asset services may become even more important - possibly absolutely essential. As a result, institutions which are frozen out of the asset side of consumer financial services will be weakened competitively to the public's disadvantage.

Consumer banks have developed over a long time to meet these needs. Hundreds of long-standing institutions with commercial bank charters have portfolios that would classify them essentially as consumer banks. Industrial banking institutions in about twenty states offer chiefly time deposits while making consumer and some small business loans. Many of these are federally insured. Savings and loan associations and mutual savings banks offer consumer transaction and time accounts and make mortgage, consumer, and some commercial loans.

Finally, but causing the most discussion, a few diversified institutions in recent years have started or acquired small consumer banks with commercial bank charters, not unlike but more limited than industrial banks. They have acquired these institutions for access to funds, for toehold entries into the payments system, to issue credit cards, to avoid overly restrictive and arbitrary state interest limitations, and to compete otherwise in the offering of new consumer financial services. They offer transaction and time deposits, make consumer loans, and have FDIC insurance.

Similarly, such companies own state or federal savings and loan associations and industrial banking companies. These companies are offering innovative products and services to consumers at competitive prices and are making a positive contribution to the nation's financial services delivery system.

Unfortunately, some people contend that diversified institutions should not be permitted continued access to consumer deposit markets. They urge regulatory elimination even though diversified companies have engaged in such activities, as evidenced by ownership of state chartered savings and loan associations and industrial banks, since the turn of the century. A variety of arguments are offered in support of the restrictive approach to deposit markets. We think these arguments overlook important considerations and are not consistent with the general principles of appropriate regulatory policy I outlined earlier.

Consumer Banks are Not Unregulated Financial Institutions. A contention reported frequently in the popular press - that consumer banks or "nonbank banks" owned by diversified firms operate pursuant to a "loophole" or in some unregulated twilight zone - is simply wrong.

By virtue of their charters issued under Federal or state banking laws, limited purpose banks are subject to the same regulations as other banks. These institutions are fully regulated financial institutions, subject to all of the laws and regulations applicable to full service banks. Some examples of these laws are appended to this statement.

In addition, all of these institutions are subject to antitrust and securities laws. Consequently, it is difficult to conclude that these companies are not already subject to extensive federal and state regulation, even if they are not covered by one more law, the Bank Holding Company Act.

Consumer Banks Do Not Thwart the Will of Earlier Congresses. On this point, last year's Supreme Court decision in the *Dimension* case - a case in which AFSA was a party - affirmed the view that earlier Congresses had not intended to regulate consumer banks under the Bank Holding Company Act.

By an 8-0 margin, the United States Supreme Court last January affirmed that Congress intended the BHCA to restrict corporate ownership of banks that both take demand deposits and make commercial loans, but not ownership of limited purpose banks. The Court's ruling emphasizes that existence of such limited purpose banks outside the BHCA is not the result of a legal "loophole," but rather is the will of Congress.

The Court did not base its decision on narrow or procedural grounds; rather, it turned its attention to the fundamental reasons why diversified companies owning limited purpose banks are exempt from the BHCA. In this context the Court considered language from the Senate which said:

> "The definition of 'bank' adopted by Congress in 1966 was designed to include commercial banks and exclude those institutions not engaged in commercial banking, since the purpose of the Act was to restrain undue concentration of commercial

> banking resources and to prevent possible abuses related to the control of commercial credit. However, the Federal Reserve Board has noted that this definition may be too broad and may include institutions which are not in fact engaged in the business of commercial loans. The committee, accordingly, adopted a provision which would exclude institutions that are not engaged in the business of making commercial loans from the definition of 'bank'." S. Rep. No. 91-1084, p. 24 (1970).

Nonetheless, three major arguments have been advanced to support the purported need for new controls over the activities of consumer banks: 1) impact on monetary policy, 2) safety and soundness of the financial system, and 3) the possibility of concentration of resources and conflicts of interest that could arise through combining finance and commerce. We also suspect an unspoken fourth argument: protection of market turf from new and aggressive competition by innovative companies.

The Arguments

Monetary Policy: Not A Factor. The first argument concerns the banking system as an important element in the transmission of monetary policy. However, the consumer bank issue concerns ownership and affiliations of financial institutions, not essential elements of monetary policy. Consumer banks and savings and loan associations issuing transaction accounts are subject to reserve and reporting requirements in a manner similar to commercial banks. Congress legislated uniformity in this area in the

Monetary Control Act of 1980. While ongoing oversight regarding the proper level of reserves, the payment of interest on reserves, the types of accounts on which to require reserves and other technical matters of monetary policy certainly seems reasonable and appropriate, these are not questions raised by the existence of consumer banks. Even if their permissible affiliates differ from those allowed under the Bank Holding Company Act, this is not a monetary policy issue. Under the Monetary Control Act, the monetary policy status of commercial banks and consumer banks is exactly the same.

Safety and Soundness: Consumer Banks Have Low Risk. The second argument concerns the safety and soundness of the banking and financial system. The issue arises because depository institutions are custodians of much of the nation's liquid wealth as well as its payments system. Certainly, everyone agrees that maintaining a safe and sound banking system is a proper role for the government. The ultimate question for consumer banks affiliated with other enterprises is whether they threaten the safety and soundness of the financial system.

Consumer banks by their very nature have portfolios of relatively low risk, high liquidity, and widely diversified assets generating a constant and substantial cash flow. In general, consumer credit assets of these institutions are characterized by short maturities and reduction of loan balances by monthly amortization payments. They are not subject to sharp fluctuations in market value, and while not salable instantaneously, the consumer credit portfolio can be sold relatively easily to generate cash. In contrast, typical commercial bank portfolios usually involve larger transactions which may be illiquid and subject to sharper market price fluctuations. The experience of this century demonstrates that the overwhelming majority of consumers repay their debts, even in the worst of economic conditions.

Beyond such normal operating considerations, a consumer bank would be less able than full-line institutions to make commercial loans to affiliates. This fact would tend to enhance currently existing restrictions on transactions among affiliates such as those found in Section 23A of the Federal Reserve Act strengthened a few years ago in the Garn-St Germain Act. Thus it does not seem that safety and soundness concerns are serious enough to argue for wholesale elimination of these consumer-oriented financial institutions from the market for financial services.

Nonetheless, some observers - even while agreeing that consumer banks are not risky in themselves - still argue that a consumer banks' affiliation with nonbanking firms somehow subjects the banks to some kind of "affiliation risk." Current law and regulations preclude

banks from providing deposit generated funds to affiliates. Any risk which might exist arises not out of the nature of the consumer bank, but out of correctible deficiencies in the deposit insurance system. It would, therefore, make better sense to correct deficiencies in the deposit insurance system rather than to outlaw consumer banks and lose the public benefits of increased competition. Academic experts, as well as the deposit insurance agencies themselves, have undertaken important reviews of the deposit insurance system. Many of the reforms they have recommended are gradually being implemented and might be further considered by this Committee.

Much of the alleged need to control risk through more regulation arises because the deposit insurance system *misprices risk*. Mispricing in the deposit insurance system has the effect of penalizing prudently managed companies that control their own risks, and rewarding those that do not effectively manage risk. As a result, the mispricing of risk invites control through regulation. In the case of consumer banks, the "control through regulation" approach would exclude firms with nonfinancial affiliates from the marketplace, regardless of the prudence of their risk management, and would violate the principle of adapting regulation to the specific problem at hand. Such an approach is inappropriate since it sacrifices the public benefits of enhanced competition. It would be much better to reform the deposit insurance system - for example, through pricing that eliminates subsidy aspects - rather than to eliminate competition.

Conflicts of Interest: Competition Is the Best Way to Eliminate Them. The third argument advanced against consumer banks is that they might increase concentration of resources or cause conflicts of interest arising from combining commerce and finance. Large-scale industrial/financial conglomerates are sometimes pictured as possible outcomes. There is no evidence of any trend to warrant such concerns. However, as with the other arguments against consumer banks, this argument does not appear relevant for institutions operating solely in the consumer marketplace. Entry of new firms should bring new capital and make consumer financial markets more competitive, rather than less so. Indeed, free right of entry by its very nature tends to combat concentrations of resources and conflicts of interest. While, obviously, the merits of large-scale combinations of commerce and commercial banking might be debated much further, it seems that much of the criticism breaks down when focusing on consumer-oriented services.

SECURITIES POWERS

Mr. Chairman, let me now turn to the other issues you have raised, beginning with the question of additional securities powers for bank holding companies. AFSA believes this issue is extremely important and actually much broader than just some limited new securities powers for one class of financial institutions. While AFSA supports the idea of additional securities powers for bank holding companies, we believe we are witnessing fundamental changes in our financial regulatory system that should be addressed by fundamental consideration of our whole system of financial regulation.

Recently, Mr. Chairman, it seems we hear about nothing but "loopholes" -- the nonbank bank loophole, the nonthrift thrift, the Delaware, South Dakota, and District of Columbia loopholes, and now most recently, the "substantially engaged" loophole. Soon, I am sure, we will be hearing about the New York and the "5000-person-town" loopholes, as well others not yet even named. But, I think it is becoming increasingly clear, even to those not closely studying financial regulation, that we do not have merely a series of loopholes here that can be closed or beaten down one by one. Rather than loopholes, what we are seeing is the crumbling of our financial regulatory system brought about by the passage of time, the march of technological progress, and the spreading globalization of financial markets.

Glass-Steagall Act. Limited purpose banks are subject to the same limits on securities activities, and interlocks and affiliates with securities firms, as full service banks.

Consumer Protection Laws. Limited purpose banks are fully subject to all of the following consumer protection measures to the same extent as full service banks: Truth-in-Lending, Truth-in-Leasing, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Community Reinvestment Act, Fair Credit Billing Act, Federal Trade Commission Improvement Act (unfair and deceptive practices), Fair Housing Act, Fair Debt Collection Practices Act, Fair Credit Reporting Act, Electronic Funds Transfer Act, State and federal usury laws and real estate Settlement Procedures Act.

Enforcement Sanctions. Limited purpose banks are as susceptible as full service banks to the powers of banking regulators to issue cease-and-desist and removal orders and to impose civil money penalties for violations of laws and regulations.

Right to Privacy. Limited purpose banks are fully subject to the Right to Financial Privacy Act of 1978.

Bank Secrecy Act. Limited purpose banks are fully subject to the provisions of the Bank Secrecy Act, which establishes reporting and recordkeeping requirements relating to currency transactions.

Bank Bribery Act. Limited purpose banks are fully subject to the provisions of the Bank Bribery Act prohibiting payments and gratuities to bank employees in connection with bank business.

The CHAIRMAN. Thank you very, very much, Mr. Evans.

Mr. Heuer, go right ahead.

STATEMENT OF ALAN J. HEUER, DIVISION EXECUTIVE, MARINE MIDLAND BANK, NY; CHAIRMAN, GOVERNMENT RELATIONS COMMITTEE, CONSUMER BANKERS ASSOCIATION

Mr. HEUER. Mr. Chairman and members of the committee; I am Alan Heuer, division executive for Consumer Banking at Marine Midland of New York. I am representing the Consumer Bankers Association [CBA] on whose government relations committee I serve as chairman.

CBA appreciates the opportunity to appear at the committee's first series of hearings in this Congress and we appreciate your attention to some of the issues which are of great concern to our industry.

RECAPITALIZATION OF FSLIC IS PARAMOUNT

In particular, we believe that your prompt attention to the FSLIC recapitalization plan and the accompanying legislation to provide for more effective authority for the regulatory agencies is of paramount importance. This legislation passed by your committee and the House Banking Committee last year is critical and should be addressed as soon as possible.

We would advocate the committee's passage of these two items before proceeding on to other topics.

CBA represents the Nation's leading commercial banks, mutual savings banks, savings and loans, and credit unions on matters affecting retail or consumer banking. Our 700-plus members together hold over 80 percent of the consumer loans and deposits in the industry. Thus, we have a particular interest in issues such as those discussed this morning affecting retail banking products.

At the same time, we have a deep concern over the inability of our members to offer many retail financial products to their customers due to legal restraints that we believe are outdated and anticompetitive.

Our testimony today reflects both of these interests. First, we will review the issue of funds availability, including some technical observations as to why banks must sometimes place holds on deposited checks due to flaws in the return item process.

We are aware of a pronounced interest in both the House and Senate in dealing with the issue and we are pleased to appear at this hearing with representatives of the consumer organizations that were on the previous panel.

We, too, sincerely favor a remedy which affords our customers speedy access to their deposits, but we believe that the risks to financial institutions must be considered as well. If there is to be Federal legislation, we ask that you review the examples set successfully in States such as New York and California where the legislation delegates the setting of availability schedules to the appropriate regulatory body.

In addition, and similar to California and New York, legislation should also contain appropriate exceptions for special cases where the schedule either cannot be met or places an unnecessary risk on a depository institution. And perhaps most important, the establishment of an availability schedule should be predicated upon modernizing the return item process to acknowledge the actual time it takes for a financial institution to know that an item is not collected.

Our testimony today sets forth several observations on funds availability. We understand a separate hearing is being scheduled in early February and we look forward to discussing the specifics of various bills which have been introduced at that time.

With regard to the issue of nonbank banks, securities powers, and the role of insurance of activities for banks, our written statement discusses in some detail our views on the need for comprehensive modernization of banking laws. This entails suggesting a number of public policy guidelines and our belief that these guidelines can be met while bringing our financial laws into line with market conditions and the need of the U.S. financial system and its consumers.

Among the guidelines we discuss are promoting safety and soundness, serving the consumer financial needs, providing financial services efficiently, and safeguarding against conflicts of interest, preventing coercion; and establishing rules that are flexible.

After reviewing the testimony of the Association of Bank Holding Companies, which you heard yesterday, we think that the concept of a diversified financial services holding company, coupled with regulatory regulations and safeguards for the payment system, is worthy of serious discussion and we endorse this approach.

We also feel that expanded products and services for banking are appropriate and would result in additional competition, better service, more convenience, and lower prices for the consumer, as discussed in the testimony yesterday by the American Bankers Association and the Dealer Bankers Association.

ADVOCATE FREER COMPETITION FOR ALL

However, this does not mean we pursue a protectionist course for banking. We do not advocate new competitive powers for banks while denying others the right to compete with us. Rather, we urge that a new set of rules be drawn up to allow for freer competition among all financial service providers in keeping with changes already underway in the market. Until such new rules are considered, we prefer that the nonbank issue be deferred and treated later as part of overall banking law modernization.

In summary, CBA's testimony concentrates on two issues. One is funds availability and the comprehensive reform of our Nation's laws regulating financial services. We have discussed each in some detail in our testimony and we look forward to working with the committee to help bring resolution.

Thank you.

[The complete prepared statement of Alan Heuer follows:]

Because we are talking about fundamental forces and changes, AFSA believes the Committee should re-examine the nation's financial regulatory system in its entirety instead of focusing on named, unnamed, and even uninvented technical "loopholes." Any legislation that is enacted should be both comprehensive and pro-competitive. Mr. Chairman, AFSA believes that this Committee has an historic opportunity this year to update our financial regulatory structure so that American financial institutions and markets can regain their declining preeminence.

DEPOSIT AVAILABILITY

AFSA understands that the varying check-hold policies of depository institutions can be an irritant to consumers. We note that the Federal Reserve Board has experimented with methods to accelerate the process of returning checks, which seems necessary if reduced holding periods are not to lead to more fraud. Without a faster return system and the ability to identify checks that pose a potential risk of loss, shortened check-hold periods may reduce one problem but create another.

AFSA urges the Committee, should it adopt some form of check hold legislation, to include an exception for small institutions -- those which are dependent on correspondent institutions and other processing providers for back-office services. For example, industrial banks, a number of which offer NOW accounts, are almost universally dependent on such outside providers and do not have the ability to control processing times. We believe such institutions should be exempt from any funds availability legislation or, at a minimum, should be granted more time for compliance.

EMERGENCY ACQUISITIONS LEGISLATION

Emergency Acquisitions Legislation or the so-called "Regulators' Bill" would extend provisions of the Garn-St Germain Act that appear to have become useful tools for regulators dealing with bank insolvencies. AFSA believes that the extension of the emergency interstate acquisition provisions of the Garn-St Germain Act is necessary. We urge that this provision and any other provisions of the Regulators' Bill which this Committee deems essential be passed in conjunction with the FSLIC recapitalization proposal and not be held up by consideration of broader regulatory issues.

FSLIC RECAPITALIZATION

Finally, Mr. Chairman, it is imperative that the Committee proceed immediately to enact a clean bill recapitalizing the FSLIC. Congress has already promised the full faith and credit of the government for FSLIC-insured deposits; now is the time to honor that commitment.

AFSA understands the complexity of this issue -- how recapitalization has become involved with questions of Federal budget accounting and with disputes about how recapitalization should be funded. Unfortunately, though, in the last Congress FSLIC recapitalization also became linked to other regulatory matters and, ultimately, nothing passed. As I have already stated, I believe this Committee should fully explore necessary changes in our regulatory system, but consideration of such changes should not hold up urgent work on the FSLIC.

We are all aware of the plight of the savings and loan industry. In spite of the temporary respite afforded that industry by today's relatively low money costs, many institutions in the industry have not significantly recovered since 1982 when portfolios of low rate mortgages exceeded the industry's book value by $125 billion. To stem this tide the Federal Savings and Loan Insurance Corporation (FSLIC) must cope with potential failures with an insurance fund of under $2 billion. Accordingly, the FSLIC has been forced to let many essentially insolvent savings and loan associations continue to operate. This, we think, is a disservice to taxpayers since it has the effect of increasing their liability that Congress has already pledged.

Mr. Chairman, AFSA urges passage of the Treasury's recapitalization plan in a form acceptable to the Congress, the administration, and the industry. We believe this plan should be passed as soon as possible - before the current fund is tested by a major failure - and without awaiting comprehensive banking legislation.

I do wish to point out that no unitary savings and loan association owned by a diversified company has failed and none is on the endangered list. This is why we believe it is healthier for such acquisitions to be encouraged and that barriers to the ownership of savings and loan associations be eased.

CONCLUSION

AFSA shares this Committee's concerns - and, we think, the concerns of all Americans - that the nation be assured of safe and efficient financial markets. These concerns can best be addressed through ongoing inquiry by the Congress and through comprehensive legislation that achieves the goal of ensuring competitive, efficient financial markets. However, we believe that such comprehensive legislation need not impede the passage of necessary emergency legislation to recapitalize FSLIC and preserve confidence in the safety and soundness of the financial system.

Thank you Mr. Chairman and Members of the Committee for this opportunity to express our views.

APPENDIX

Laws Governing Limited Purpose Banks

Examinations. Limited purpose banks are regularly examined by the same state and federal banking authorities that examine full-service banks.

Affiliate Lending. Limited purpose banks, like as full-service banks, are subject to Section 23A of the Federal Reserve Act. This law restricts lending to any one affiliate to 10% of the bank's net worth, and limits lending to all affiliates in the aggregate to 20% of net worth. Purchase of assets from affiliates, investments in the securities of affiliates and guarantees issued on behalf of affiliates are also subject to these limits.

Even within these volume limits, loans to affiliates must be at least 100% collateralized, and all transactions with affiliates are required to be "consistent with safe and sound banking practices." Section 23A further restricts the purchase by a bank from an affiliate of a "low-quality" asset.

A loan made to a third party where the proceeds are used for the benefit of an affiliate or are transferred to an affiliate, is deemed to be a loan to the affiliate itself and is subject to Section 23A limits. There is, therefore, no greater risk that limited purpose banks will be used to advance the interests of affiliates than in the case of full service banks.

Insider Lending. Limited purpose banks are subject to all of the same limits as full service banks imposed by Section 22 of the Federal Reserve Act and Regulation O on loans to executive officers, principal shareholders and entities controlled by such persons. The aggregate of all loans to any such person and his related entities cannot exceed the bank's limit on loans to a single borrower. Loans to such persons and entities, as well as loans to directors, cannot exceed $25,000 or 5% of the bank's capital and unimpaired surplus (but in no event more than $500,000), and all such loans are required to be nondiscriminatory, in terms of interest, collateral and payment risk, as compared to loans to persons unrelated to the bank.

Margin Regulations. Limited purpose banks are subject to the same margin rules (Regulation U) - that is, rules relating to lending for the purchase of securities - as are full service banks.

Reserve Requirements and Deposit Interest Rate Controls. Limited purpose banks are subject to the same reserve requirements (Regulation D) and deposit interest rate limits (Regulation Q), as full service banks.

Capital Adequacy. Limited purpose banks are subject to the same capital requirements and guidelines as full service banks, and are fully subject to the authority of the federal bank regulators under the International Lending Supervision Act of 1983 to set and enforce levels of capital adequacy for individual banks.

Dividend Limits. Limited purpose banks may only pay dividends to their shareholders under the same circumstances as full service banks may pay dividends.

Lending Limits. Limited purpose banks are subject to the same limitations on loans to a single borrower as full service banks.

Payments System. Limited purpose banks are fully subject to the Federal Reserve's Regulation J, which governs check collection and wire transfer procedures.

Discount Window Advances. Limited purpose banks are not permitted access to the Federal Reserve discount window except on the same terms and conditions as full service banks.

"Nonbank" Activities. Limited purpose banks may not engage directly or through subsidiaries in any activities that would be prohibited to their full service counterparts under state or federal law.

Changes in Control. The acquisition of limited purpose banks is subject to extensive regulation. No person or company may acquire a limited purpose bank without full scrutiny by a federal bank regulator. Under the Change in Bank Control Act, the federal authority may deny permission to acquire such a limited purpose bank if it finds (a) that the financial condition of the acquiring entity might jeopardize the financial stability of the bank or prejudice the interests of depositors; (b) that the competence, experience or integrity of the acquiring entity is such that it would not be in the interests of depositors or the public to permit the

acquisition; or (c) that relevant antitrust standards would be violated. These are the same standards applicable under the Change in Bank Control Act to acquisitions of full service banks.

Chartering and FDIC Insurance. Any persons or company that proposes to charter a limited purpose bank, or to obtain federal deposit insurance for such a bank, must satisfy all of the financial, managerial and other standards as are applicable to full service banks. Once FDIC insurance is granted, limited purpose banks pay the same premiums, and are subject to the same assessments, as full service banks.

Bank Merger Act. Any merger involving a limited purpose bank is subject to scrutiny on antitrust grounds, both by a federal banking agency and by the Department of Justice.

Branching. Limited purpose banks are subject to the same state and federal limitations on branching as are full service banks.

Management Interlocks. Officers, directors and employees of limited purpose banks are subject to the same limits on interlocking service with other depository institutions as their counterparts in full service banks.

Unlawful Tying Practices. Limited purpose banks are subject to those federal antitrust laws, including Section 3 of the Clayton Act and Section 1 of the Sherman Act, that prohibit anti-competitive tying arrangements and that provide treble-damage and injunctive remedies for violations.

TESTIMONY OF
THE CONSUMER BANKERS ASSOCIATION
BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

PRESENTED BY ALAN HEUER
JANUARY 23, 1987

Mr. Chairman and members of the Committee, I am Alan Heuer, Division Executive for Marine Midland Bank of New York. I am representing the Consumer Bankers Association, on whose Government Relations Committee I serve as Chairman.

CBA appreciates having the opportunity to appear at the Committee's first series of hearings in this Congress, and we appreciate your attention to some of the issues which are of great concern to our industry. In particular, we believe that your prompt consideration of the FSLIC recapitalization plan, and the accompanying legislation to provide more effective authority for the regulatory agencies, is of paramount importance. This legislation, passed by your Committee and the House Banking Committee last year, is of great importance and should be addressed as soon as possible. We would advocate the Committee's passage of these two items before proceeding on to other topics.

CBA represents the nation's leading commercial banks, mutual savings banks, savings and loans, and credit unions on matters affecting retail, or consumer banking. In that capacity, we have a particular interest in issues affecting retail banking products. At the same time, we have a deep concern over the inability of our members to offer many retail financial products to their customers, due to legal restraints we believe to be outdated and anti-competitive.

Our testimony today reflects both of these interests. First, we will review the issue of funds availability, including some technical observations as to why banks must

sometimes place holds on deposited checks due to flaws in the return item process. We are aware of a pronounced interest in both the House and Senate in dealing with the issue and we are pleased to appear at this hearing with representatives of several consumer organizations.

We, too, sincerely favor a remedy which affords our customers speedy access to their deposits, but we believe that the risks to financial institutions must be considered as well. If there is to be federal legislation, we ask that you review the examples set successfully in states such as New York and California where the legislation delegates the setting of availability schedules to the appropriate regulatory body. In addition, and similar to California and New York, legislation should also contain appropriate exceptions for special cases where the schedule either cannot be met or places an uncessary risk on the depositary institution. And, perhaps most important, the establishment of an availability schedule should be predicated upon modernizing the return item process to acknowledge the actual time it takes for a financial institution to know an item is not collected.

Our testimony today sets forth several observations on funds availability. We understand a separate hearing is being scheduled and we look forward to discussing the specifics of various bills which have been introduced at that time.

With regard to the issues of non-bank banks, securities powers and the role of insurance activities for banks, we have outlined in some detail our views on the need for comprehensive modernization of banking laws. This entails suggesting a number of public policy guidelines and our belief that these guidelines can be met while bringing our financial laws into line with current market conditions and the needs of the U.S. financial system and its consumers. Among these guidelines are:

- promoting safety and soundness,
- serving consumer financial needs;
- providing financial services efficiently;
- safeguarding against conflicts of interest;
- preventing coercion; and
- establishing rules that are flexible.

After reviewing the testimony of the Association of Bank Holding Companies, which you heard yesterday, we think that the concept of a diversified financial services holding company, coupled with functional regulation, and safeguards for the payment system, is worthy of serious discussion, and we endorse this approach.

We also feel that expanded products and services for banking are appropriate, and would result in additional competition, better service, more convenience, and lower prices for the consumer, as discussed in testimony yesterday by the American Bankers Association and the Dealer Bankers Association.

However, this does not mean we pursue a protectionist course for banking. We do not advocate new competitive powers for banks while denying others the right to compete with us.

Rather, we urge that a new set of rules be drawn up to allow for freer competition among all financial service providers in keeping with changes already underway in the market. Until such new rules are considered, we prefer that the non-bank issue be deferred, and treated later as a part of overall banking law on moderization.

In summary, CBA's testimony concentrates on two issues: funds availability and the comprehensive reform of our nation's laws regulating financial services. We have discussed each in some detail and look forward to working with the Committee to help bring about a resolution.

Funds Availability

Because the Consumer Bankers Association was established to provide a voice for the consumer services sector of the banking industry. the issue of funds availability is a major concern for CBA members. The CBA has consistently supported disclosure policies for funds availability, and was an early proponent of this concept as it was embodied in legislation introduced by Senator Dodd. As you know, this legislation was later incorporated into Senator Garn's omnibus banking legislation.

CBA continues to believe that federal legislation, especially in the form of a mandated availability schedule must give serious consideration to the attendant risks to depository institutions. At the same time, we believe that depositors should be entitled to have the use of deposited funds as rapidly as is possible and they should be informed of funds availability policies. In addition, interest on funds deposited into interest bearing accounts should be credited promptly. CBA, is however, concerned that attempts to effect these goals may lose sight of principles that help assure the efficiency, safety and soundness of the payments system.

The banking industry has become more responsible with regard to informing consumers of its policies and shortening its hold periods. Nonetheless, we acknowledge that many members of Congress support the concept of funds availability legislation. Senator Dodd has introduced S. 344, the "Fair Deposit Availability Act of 1987" this week and CBA plans to to testify before his subcommittee on February 5, 1987. At that time we will address Senator Dodd's proposal in detail. Today, we will discuss general industry concerns about legislation in this area, the necessity for hold periods in certain circumstances against a backdrop of legal and operational check processing considerations and to conclude with some general observations on federal legislation.

Funds availability schedules are not the result of arbitrary policy making, but rather the result of fundamental flaws in the check collection system that adversely affect both banks and their customers. These flaws stem from the manual system of processing returned checks, as well as technical and legal impediments. They must be addressed in any legislation that attempts to expedite funds availability.

To illustrate this need, we would like to provide some background on the present check collection system and its impact on the availability of deposited funds.

National Check Collection System

The question of deposit availability must be considered in light of the provisions of the Uniform Commercial Code, adopted by all states, and of the national check clearing system. When one bank takes for deposit a check drawn on another bank, it must send the check through the national check collection system to obtain the funds the check represents. Checks may be collected through a correspondent bank, the Federal Reserve System, a local check clearinghouse, or by sending the item directly to the payor bank on which it is drawn. In most cases, some combination of these methods is used.

The forward process of sending a check to the payor bank has benefitted from technology and generally takes only one or two business days from the date the check is first deposited. The actual time required will depend on a variety of circumstances, such as the location of the institution, the number of intermediary institutions involved, holidays, weekends, weather, and mechanical breakdowns.

After receiving the check, the payor bank is required by the Uniform Commercial Code either to pay it or to return it unpaid by midnight of the day following the day it receives the check. The depositary (bank of first deposit) bank receives "provisional credit" for the check from the institution to which it delivers the check according to an availability schedule. That schedule reflects normal processing and transportation time for the forward process only, usually one or two business days. Since it is unknown whether the specific check will in fact be paid, any such grant of credit must be provisional and may be revoked if the item is returned unpaid.

Due to the uncertainty of whether it will receive final credit, the depositary bank will be making a loan to the depositor if it allows the depositor to withdraw funds at the same time that the bank receives provisional credit. In this situation, the bank is at risk that the item will be returned unpaid and that the provisional credit will be revoked. If this occurs, the bank may be unable to recover the funds withdrawn by the depositor.

The forward check collection process is relatively fast (usually within a few days), particularly since Magnetic Ink Character Recognition (MICR) encoding allows the use of high speed processing equipment.

The return process is manual, however, and therefore considerably slower. For a returned check, each endorsement stamp on the back of the check must be read to determine to which bank or institution the check must next be returned. Each bank in the return process dispatches a returned check to the next succeeding bank by midnight of the next business day following the day of receipt. Often the institution merely places the check in the mail by the midnight deadline. Accordingly, the return process is considerably longer than the forward process.

Reasons For Delayed Funds Availability

More than ninety-nine percent of all checks are paid upon presentation. It is the less than one percent that are not paid that require banks to place holds on the proceeds of some items in order to protect themselves. If banks were not permitted to place holds, they would be open to substantial losses from fraud and ordinary credit

risk from funds advanced on items subsequently returned. The only way a depository institution can protect itself fully against fraud or credit loss on a particular item is to allow depositors to withdraw only against collected funds. Due to the delay involved in learning of the return, hold times to protect the bank and its customers may be lengthy.

Critics of bank hold policies frequently argue that the relative insignificance of bad check losses as a percentage of total dollars cleared shows that most holds are either unnecessary or too long. Although bad check losses are a small percentage of the total dollars cleared, the absolute numbers are not small. According to House Banking Committee statistics, 140 million checks are returned unpaid the second time. A survey conducted by the Bank Administration Institute found that the average amount of these checks in 1985, was $869.00 which could result in exposure considerably in excess of $121.7 billion. Similarly, a single west coast bank member of CBA calculated that over the last three years it lost an average of $2.1 million annually on "bad" checks which it could have averted if it had chosen to place holds when the items were deposited. Those losses accounted for 20-25% of its total annual losses attributable to operations. Though this institution holds only about .03 percent of the items processed, and decided that it would rather incur these losses than aggravate customers with a more aggressive hold policy, the losses obviously are not insignificant.

Moreover, the length of a particular hold is a function of how long it takes the payment system to return a dishonored item to the bank of original deposit. If the hold is released before the "bounced" item returns, it is a pointless exercise. In short, a hold placed on the availability of funds represented by a particular deposit - perceived as risky - must be of sufficient duration to afford actual protection.

Most critics largely ignore or discount the deterrent value of hold policies generally. Although there is no empirical evidence on this point of which we are aware, common sense suggests that the check kiters and fraud artists would have increased incentives to engage in illegal activity if holds were never placed or, as would be the case under many legislative proposals, the maximum permissible hold periods were inherently inadequate in certain circumstances. Undoubtedly, bad check losses would be higher in the absence of hold policies.

Another important factor causing banks to place holds is that state and federal regulatory agencies supervising depository institutions have taken the position that allowing depositors to withdraw against uncollected funds is tantamount to extending credit to the depositor. Such credit extensions must be included in determining whether a financial institution is adhering to applicable legal lending limits and in analyzing whether the institution is acting safely and soundly as required by banking laws.

Federal Legislation

Senator Dodd's bill, S. 344, entitled the "Fair Deposit Availability Act of 1987", and H.R. 28, the "Expedited Funds Availability Act", introduced by Congressman St Germain are evidence of Congressional concern over this issue. CBA plans to analyze the bills at length during scheduled hearings, but we would like to take a few minutes today to address some general concerns.

First, legislation must address the problems of the return system. Depositary institutions should be able to quickly determine whether the item is collectable and they cannot do so unless the return system is changed. The return process must be synchronized with any availability schedules to alleviate unnecessary risks.

Second, if Congress decides to mandate an availability schedule, we ask that the authority to design a schedule be given to the Federal Reserve Board. The Board is particularly well suited for this responsibility because it oversees the payment system, and is familiar with its intricacies. A regulated rather than a statutory schedule would provide the necessary administrative flexibility. In New York and California, schedules were promulgated by the banking regulators, and in both instances, the regulators met extensively with representatives from consumer groups and financial institutions before the regulations were issued. Even so, subsequent changes to the regulations have been made to address problems and to ensure that the regulations were effective and efficient.

Third, it is necessary that legislation include provisions for exceptions from the schedule. The exceptions should be flexible and provide extra time for those circumstances in which the financial institution has no experience or bad experiences with its customers, or if that institution believes that the funds are uncollectable and if the situation is beyond the control of the institution. For example, both New York and California permit institutions to delay the availability of funds for

new customers, and for emergencies beyond their control. These exceptions, and a number of others, are necessary to ensure that depository institutions operate without undue risk.

Educating Consumers

As we have stated, there are compelling reasons for imposing holds on checks. Until fairly recently, however, many depository institutions did a less than satisfactory job of clearly disclosing to their customers that a hold was being placed on a particular deposit. Accordingly, some customers unwittingly wrote checks against unavailable funds and they were understandably upset when the check was not paid. Most banks are now addressing this problem and legislation has been passed in approximately thirteen* states, including New York and California. Moreover, financial trade associations such as CBA have been exhorting their members to disclose their policies voluntarily and the industry is responding.

It has been reported that during the Federal Reserve Board's consumer compliance examinations for 1984, 1985 and 1986, approximately 1100 state member banks** were surveyed on their funds availability policies.

The results showed that a majority of institutions had policies and that 70% of them disclosed those policies to the consumer when the account was opened.

A vast majority of the institutions (81%) either held checks only on an exception basis, or did not place any hold at all. Of the remaining institutions surveyed, only 15% placed holds on certain types of checks and 4% placed a hold on all checks.

Furthermore the public perception regarding the speed and rapid evolution of EFT and ATM deployment does not square with the archaic reality of the return item system and consumers need to be informed of the reasons for delay. Again, the industry has begun to explain the problem to their customers.

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* California, Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Missouri, Montana, New Jersey, New York, Oregon, Rhode Island, and Wisconsin.

** Includes state member banks and decentralized branches that set their own policies.

A delay in funds availability, although a rare occurrence for most customers, nevertheless can create a tremendous inconvenience when it occurs. It is an experience not easily forgotten. When a hold does occur, customers overlook the fact that many deposited checks are not "held" and the systemic reasons for holds are not usually known or appreciated. Therefore, in addition to disclosing hold policies, the industry must continue its efforts to educate the public on the reasons for a delay in funds availability.

Conclusion

In recent years financial institutions have made tremendous strides in the area of funds availability. A majority of institutions have adopted justifiable policies and disclose these policies to their customers. Many place holds only in special circumstances. If Congress, however, believes that it is necessary to enact legislation, we respectfully request that at least the following concepts be included:

- o An availability schedule that is promulgated by the appropriate federal regulatory agency and predicated on improvements to the return system so that the schedule and knowledge of the "collectability" of an item are synchronized.
- o Exceptions to the schedule that are extensive and flexible enough to ensure that the financial institution does not assume unnecessary risks due to fraud, insolvency, lack of experience or bad experiences with customers or circumstances beyond its control.

In today's very competitive consumer financial services market, it is in the best interest of financial institutions to provide products and services that attract and keep customers. The safety and efficiency of the payment system, however, must be a paramount consideration. To this end the Consumers Banking Association welcomes the opportunity to provide information or assistance on the issue.

The Consumer Bankers Association's Perspective On Restructuring The Financial Services Industry

Since CBA's constituency primarily represents those divisions of depository institutions that provide products and services to individual consumers, rather than to corporations, we bring a retail banking perspective to issues related to the structure and regulation of the financial services industry. This consumer banking focus enables CBA and its members to experience first hand the needs and expectations of consumers.

We also believe that this consumer viewpoint is, and should be, a primary focus of the financial services restructuring debate that is raging today in the financial services industry and the Congress. While the debate necessarily extends to corporate banking issues as well, CBA believes that the principal impetus for change is laws that are so seriously outmoded as to prevent banks* from efficiently meeting the needs and demands of consumers and, thus, the marketplace in general.

While our primary focus is on retail banking and its ability to meet market demands, we recognize that we must take a broader perspective for two major reasons. First, we believe that in order to be effective, any reform effort must be comprehensive. Thus, we must address issues throughout the entire financial services sector, rather than just those that affect consumer financial services. The growing integration of financial products and services -- such as the recent movement toward securitization of consumer obligations -- renders at best artificial a clear line separation of consumer and commercial financial services. Moreover, the concerns, principles, goals and solutions described below apply with equal force to corporate financial services. Thus, we will address the financial services industry as a whole, and not just the consumer financial services segment of that industry.

Second, and on a more philosophical plane, we believe that these issues must be analyzed from a public policy perspective, and not from the viewpoint of any specific organization, financial services provider or interest group. Thus, we have done our very best to analyze these issues from the viewpoint of what is in the best interests of the public and what promotes sound public policy rather than what we believe to be good for retail banking or even the entire banking industry. Having said that, we recognize that many policymakers believe that in certain respects public policy and banking interests are parallel since they view the strength and health of the banking system as being integrally related to the economic welfare of the country. However, we have truly endeavored to set aside our parochial views in preparing this analysis.

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* Except where specifically indicated or where the context indicates otherwise, throughout this analysis, all references to banks, banking and the banking industry include not only commercial banks, but thrift institutions as well.

CBA's Analysis

CBA's analysis is divided into four parts. First, we will suggest basic public policy principles that we believe should establish the analytical framework for evaluating today's financial services regulatory structure and for guiding the changes that must be made in those laws. We believe that identifying and gaining a broad-based consensus on these principles and goals are essential to any meaningful analysis of the needs of the current financial services marketplace and to the development of a plan for reform of the regulatory structure governing the industry that serves that marketplace.

Next, we will address how existing law and the resultant structure of the financial services industry are failing to meet those principles and goals. Third, we will propose a general framework for change by describing the structural changes that should be effected by any legislation. Finally, we will demonstrate how the changes that CBA recommends would facilitate the attainment of those principles and goals.

I. Principles And Goals For Financial Services Restructuring

CBA believes that six primary principles and goals should form the basis for analysis of the financial services industry today and should guide the development of regulatory changes that govern the evolving financial services industry. Those six principles are as follows.

1. Promote safety and soundness. The most important goal for the evaluation of the current regulatory system and future changes to that system should be the maintenance and promotion of a safe and sound financial system. A safe and sound financial system is essential to the preservation of an orderly economic system for both consumers and businesses. A stable and secure economic framework is critical in order to guarantee a continued flow of commerce, to protect consumer and corporate savings and to assure equitable and affordable access to credit and capital by consumers and corporate America. Without question, a sound financial system is the linchpin of our nation's economy. Thus, both existing and revised regulation must foster a safe and sound financial system. An essential corollary is that financial regulation must not in any way jeopardize the safety and soundness of that financial system.

2. Serve consumer financial needs. Another primary goal of financial services reform must be to meet the needs of consumers and the marketplace at large. CBA believes that due to changed demographics and modern technology, today's marketplace mandates that consumers be provided with the broadest possible array of financial services options conveniently and efficiently. While there has been little significant change during the past 50 years in the legal structure that governs the financial services industry, over the same period much has changed in the area of technology and consumer needs and expectations. Clearly, today's financial services consumers have vastly different needs than those of 50 years ago and all financial services providers should be permitted to meet those needs.

3. Provide financial services efficiently. Efficiency is the third important principle that should guide the evaluation of the current financial regulatory structure and its reform. The consumer is entitled to receive financial services at a reasonable cost -- not inflated by systemic inefficiencies and unproductive costs -- and from providers who can offer all possible services and products. Consumers should not be forced to visit four different providers to shop for four different, yet often comparable or even interchangeable, products.

4. Safeguard against conflicts of interest. Irrespective of the degree to which changes in the regulatory structure may create advantages of greater choice and convenience and lower prices, if conflicts of interest are allowed to taint the system, the consumer cannot be well served. Thus, the fourth goal must be to maintain existing safeguards against conflicts of interest and to strengthen them if necessary.

5. *Prevent coercion*. Consumers must feel free to select from among various products and services and their providers without coercion. Coercion is most likely to arise where a provider forces a consumer who wants to buy one service or product to buy another as well. Thus, both explicit and implicit tie-ins must be prevented. As discussed below, the Bank Holding Company Act and the antitrust laws are existing deterrents to tie-ins to the extent that a single service provider now can provide compatible products and services. It is essential to ensure that existing, and if necessary enhanced, safeguards against coercion continue to work and work effectively.

6. *Establish rules that are flexible*. The final principle that CBA believes must guide financial services reform is that the laws governing the financial services industry should not be static and inflexible, but instead should include sufficient flexibility to accommodate technological and marketplace changes. Although the regulatory structure must be designed to maintain a safe and sound financial system, that structure should not be so inflexible that it constrains the orderly and reasonable development and evolution of the industry in response to marketplace demand.

CBA respectfully submits that these six principles should serve as the foundation for a critical analysis of both the existing financial regulatory structure and proposals for its revision. In approaching these difficult and complex issues, we believe that all participants -- the diversity of financial services providers from all industry sectors as well as consumers -- must reach a clear consensus on the objectives and goals that the financial system should achieve. We believe that the foregoing principles serve that function. Nonetheless, we would support any meaningful efforts to refine or change them or even develop additional goals that will serve public policy objectives and consumer needs. Only by clearly identifying the eventual objectives for a financial system and then working to develop a regulatory structure that will meet these objectives is it possible to bring the financial services industry into the modern age.

Subject to efforts by others to refine those proposed principles further, we first will proceed to test the current regulatory structure against them. Then, we will suggest a structure that better satisfies these principles.

II. The Current Regulatory Structure Does Not Fulfill These Goals

Changed demographics and technological advances have reshaped the marketplace making obsolete the constraints of current law. Perhaps even more troublesome, the regulatory structure designed to protect and serve the consumers of all types of financial products and services no longer does either. Before considering the specific ways in which the current regulatory structure fails to meet these principles, it is helpful to look briefly at the major changes that have reshaped our social and regulatory environment.

A changed environment. Perhaps most fundamentally, our personal and business societies have undergone major changes. Fifty years ago, when most of the laws that continue to shape our industry were enacted, the typical consumer's financial needs were exceedingly limited. Savings and investments generally were in the form of passbook savings, cash was the principal transaction medium, and the home mortgage was the principal, and often only, consumer debt.

Americans and their financial needs have changed dramatically since the early 1930s when most of the regulatory structure was established and even since the mid-1950s when the Bank Holding Company Act was enacted. Urbanization, increased mobility, greater affluence, more two income families and heightened financial sophistication, as well as a multitude of other socioeconomic factors, have altered for all time the financial services that are sought by consumers. Today, the financial assets of American households are spread across tens if not hundreds of product lines. Typically, a consumer will be involved in an array of savings, investment, transactional and credit products.

Moreover, technological advances now permit the delivery of these products instantaneously, without regard to distance. The technological ability to efficiently provide a full array of financial services, when coupled with the natural synergy that exists among all financial services products -- whether those products are within the domain of the banking, insurance or securities sectors as they were devised by a legal regime basically established 50 years ago -- virtually requires a change to the legal structure in order to permit financial services providers to offer "one-stop shopping" for all financial needs. In fact, in response to a survey, 86 percent of U.S. households stated that one-stop financial shopping would be advantageous to them.[1]

Major shifts also are occurring in the corporate world as corporate America relies less and less on banks for both its long and short-term credit needs. Instead, the marketplace is meeting those needs through the development of various new and innovative financing and funding devices. In addition, markets have become more national and international, so that both individual and business consumers are aware of the greater availability of products and services.

In many cases, however, these consumers are frustrated from realizing the benefits that might result from these changed circumstances and technological advancements due to product and geographical restraints imposed by obsolete laws. While the marketplace has undergone and is still undergoing fundamental changes in response to a virtual revolution in demographics and technology, the financial services industry continues to be governed by a set of laws that were devised in a different era.

In assessing the continuing suitability of these laws, it also is necessary to recognize the differences between the regulatory setting when they were adopted and that setting today. The Glass-Steagall Act, which was enacted in 1933, was in response to perceived hazards attributable to the largely "unregulated" commercial banking and investment banking industries. It is both unfair and unrealistic, however, to continue to justify these restraints on the basis of the state of the regulatory landscape and the resulting marketplace occurrences that existed over 50 years ago.

Since the 1930s, extensive protections have been built into both banking and securities laws to protect consumers and the marketplace against such abuses as may have been present in an earlier time. These protections need not be abandoned now. The deposit insurance system was established, laws were enacted to insulate banks from their affiliates and to prevent banks from providing excessive funds to them, bank supervision has been substantially enhanced and significantly greater disclosure about bank and bank holding company performance is now being provided to regulators and the public.

Similarly, extensive securities protections have been in place since 1933 and 1934 and other laws, such as the Investment Company Act and the Investment Advisors Act, regulate specific securities products and segments of the securities market. In addition, antitrust laws, federal and state fiduciary requirements, and a multitude of other checks and balances now regulate and permit oversight of the financial services industry. Finally, significantly greater competition at national and international levels, as well as vastly increased capabilities for data dissemination, provide a degree of market discipline that simply did not exist 50 years ago.

Against this historical backdrop, it is important to assess whether the current financial services industry structure, as it has been molded by existing regulatory constraints, fulfills the principles and goals described above. First, does the current regulatory structure maintain and promote a safe and sound financial services system or does it instead jeopardize the system's safety and soundness? Second, is competition being enhanced so that consumers are being provided with the best, most convenient and least expensive options in selecting financial products and services? Third, does the current regulatory system produce an efficient, cost-effective financial system? Fourth, is that system appropriately flexible to deal with changed circumstances?

1. The current regulatory system is antithetical to the safety and soundness of the banking system. CBA believes that the current regulatory system no longer can be said to guarantee a safe and sound financial system. It is necessary only to look at marketplace events to see that the industry structure mandated by existing law does not necessarily assure the safety and soundness of the banking system and, in fact, may contribute to a contrary result.

The past decade has seen an acceleration in the changes adversely affecting the banking industry. Market shifts away from traditional banking products and services, bank failures and general market share erosion supply ample evidence of the fact that the regulatory status quo is injurious to the maintenance of a safe and sound banking system. This can be demonstrated by looking at the specific losses in liabilities, credit outstandings, market share and profitability. Ultimately, and regrettably, the final proof is reflected in the figures respecting failed banks. Before looking at these statistics, however, I will cite one empirical example of the direct role that the regulatory system has played in this deterioration.

During the late 1970s and early 1980s, the banking industry witnessed an erosion of deposits that was "cured" by eventual Congressional action. With the helpful perspective of hindsight, through this example we are able to see objective evidence documenting the detrimental effect of outmoded laws. The vivid example was the money market fund experience, which spawned a new financial vehicle that continues to be popular today.

Before the Garn-St Germain Depository Institutions Act of 1982, money market funds expanded to more than $230 billion during a period of a few years, most of which was at the expense of traditional bank deposit relationships.[2] The increasing rate of this disintermediation was stemmed, however, with the approval of the so-called Money Market Deposit Account in 1982. In less than one year, funds in these new accounts at depository institutions grew to more than $350 billion. Despite the popularity of the newly authorized accounts, however, money market funds apparently have created a new niche with the American public. This continuing tribute to the costs of delay incumbent in after-the-fact revisions to an unduly restrictive regulatory environment has resulted in substantial losses to the deposits of depository institutions as the total invested in money market funds has stabilized at an amount in excess of $200 billion during the last two years.[3]

Another example of increased investment alternatives that have drawn funds from depository institutions -- and one that has increased rapidly in importance given recent trends in both interest rates and the stock market -- is the fact that the market share of mutual funds has more than doubled and the amount invested in such funds has more than tripled to nearly $300 billion since 1982.[4] Due to seriously outmoded laws, the banking industry is unable to benefit from these marketplace shifts and is losing market share to those that are not similarly constrained. The resultant shift of substantial funds away from depository institutions has reduced profitability and thus the overall strength of these institutions and the banking industry generally.

At the same time, the banking industry now is seeing a rapid trend in the displacement of certain of its

traditional commercial lending activities by nontraditional financial participants. While commercial banks historically have been the principal credit intermediaries in our economy, they are rapidly losing that status in both the wholesale and retail banking sectors.

The increased use of high yield bonds and commercial paper by domestic nonfinancial corporations, has reduced substantially some of the banking industry's traditional, less risky and more profitable credit markets. The Federal Reserve Board has developed a chart, attached as Appendix A, that amply demonstrates the fact that U.S. banking's share of short and intermediate term credit has declined dramatically during the past 20 years. While the banks' share of this market was consistently between 85 and 90 percent from 1950 to 1970, their share dipped to as low as 60 percent around 1982 and has remained at between 60 and 65 percent since that time.[5]

Statistics in the international market provide further evidence of this erosion. New syndicated Eurobank loans* dropped from $97 billion in 1981 to only $22 billion in 1985. However, during the same four year period, international bond and note issuances rose from $44 billion to $163 billion. In 1981 there was $1 billion in note issuance facilities created, while $49 billion was created in 1985.[6]

Other examples abound. In commercial mortgage lending, four insurance-based companies make a greater volume of commercial mortgage loans than the 15 largest bank holding companies and more than a quarter of the volume of all of the nation's banks.[7] Nonbanks already dominate the business lease financing market -- in a recent study, 15 selected companies had a larger amount of lease receivables than domestic offices of insured banks.[8]

The market share the banking industry has lost in recent years, seemingly has been gained largely by the securities industry. The amount of outstanding commercial paper placed or acquired by nonfinancial corporations has more than tripled since 1978 and the number of commercial paper issuers has more than doubled.[9] During the past decade the commercial bank share of total short-term credit to manufacturing corporations with more than $1 billion in assets has dropped by almost half -- from 49 percent of the market to 26 percent. This was during the approximate period that corporate bond issuances quadrupled.[10]

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* Eurobank loans are loans made in Eurocurrencies -- namely, in a foreign currency that is deposited with a bank outside the country where the currency is used as legal tender.

Similar erosion has been occurring with respect to consumer credit. Of the top 15 consumer installment and revolving credit lenders in 1981 and 1982, only five were banks or bank holding companies.[11]

One primary example of that erosion is the increase over the past eight years of the use of captive finance companies to finance their parents' products. General Motors Acceptance Corporation, Ford Motor Credit and Chrysler Credit are just a few examples of nontraditional providers of financial services that have had the effect of materially reducing the ability of banks to compete in the financial services market. In 1978, 50 percent of new automobile credit was provided by commercial banks, and only 25 percent by finance companies. Four years later, in 1982, the situation had been totally reversed. In 1982, finance companies were responsible for 72 percent of all new car credit, while the commercial banks' share had dropped to 16 percent. Perhaps even more significantly, the dollar volume of new car credit granted by commercial banks diminished by more than 92 percent during the same period.[12]

It is difficult at this time to see where that trend will end. Clearly, the automobile industry sees this as a growth area, since within the past few weeks the largest car manufacturer announced a program of 2.9 percent financing, another dropped its rate to 2.4 percent and a third then announced a plan for 0 percent financing. If all sellers of goods determine to undertake a massive infusion of consumer credit to subsidize the sales of their products -- in the process hiding the true cost of the credit and eliminating any potential for realistic price competition -- the traditional banking industry could easily see an even further massive loss of consumer credit market share. CBA cannot be viewed as an alarmist for making such predictions in light of the automotive industry's success in (and possibly even addiction to) these programs and the impending tax reform legislation

that by eliminating the consumer interest deduction will refocus attention on the rates being paid for credit.

As banking's traditional credit "franchise" is being eroded quantitatively, it also is experiencing qualitative deterioration. The industry still is forced by the nature of its narrow franchise to continue to provide credit to sectors of the economy that do not have other, more favorable, funding options. While corporate America and to a more limited extent consumers have turned to other markets, banks continue to be the primary source of funds to other, not so healthy, sectors of the economy. As the Congress is painfully aware, the banking industry has a significant amount of funds committed to agricultural and energy loans and to loans to less-developed countries.

As of December 31, 1984, FDIC-insured commercial banks had a total of $82 billion in receivables for extensions of credit to agricultural concerns and foreign governments.[13] These loans often involve substantial risk and thus have been significant contributors to bank failures. Fully one-third of the banks that failed in 1984 were banks that engaged largely in agricultural lending. These institutions held a combined total of $199 million in farm loans.[14] At one point in August of this year, 46 of the 93 federally insured banks that had failed were farm banks.[15] Foreign loans also have contributed to the woes of U.S. banks. A good example is the losses incurred by U.S. banks in Paraguay after the virtual collapse of South America's economy in the early 1980s.[16]

The risks to safety and soundness in the current banking industry structure are demonstrated further by the declining market share of commercial banks and other financial institutions in providing financial services in U.S. markets. Banks once were the predominant financial institution with more than 57 percent of private domestic financial institution assets in the United States. This role has declined by nearly half.[17] Moreover, while in 1982 23.5 percent of all private-sector lending was undertaken by commercial banks, in 1985 that figure was reduced to 16.1 percent.[18]

Predictably, all of these changes in the banking industry's role in commercial and consumer credit markets have had a direct impact on profitability. From 1977 to 1982, the average annual increase in commercial bank revenue was almost half that of investment companies.[19]

Savings and loans fared even worse. During that same period the profits of securities firms grew by 665 percent, more than ten times the rate experienced by commercial banks, while investment firms posted a 489 percent increase in profits, nearly eight times that of commercial banks.[20] Clearly, while the securities industry is flourishing, depository institutions are laboring mightily to maintain acceptable performance levels.

The Comptroller of the Currency also has provided some telling evidence. The average return on assets for the 4,500 community banks with national bank charters has declined in each of the past six years. During those years, the percentage of all national banks with losses has increased five-fold, while the percentage of banks with high earnings (defined as return on assets of 1.5 percent) has fallen by more than one-third.[21]

The effect on safety and soundness of forced specialization and lack of diversification is evidenced in the increased incidence of bank failures. Last year, 120 federally insured banks failed, compared with about 70 in 1984, fewer than 50 in 1983, and only 10 in 1981.[22] This year, in only the first eight months, 100 federally insured banks failed, which the Chairman of the FDIC has predicted could grow to as many as 160 by year end.[23] Commercial bank regulators now have more than 800 banks on their "problem bank" list. This list is known to include some of the country's largest institutions.[24] Currently, about a dozen $1 billion-plus holding companies are ailing. Seven of them have combined debt of $4.8 billion, some of which already is in default.[25]

As evidenced by the profitability and failed bank statistics just cited, the traditional banking industry sector of the financial services market seems to be particularly hard hit by the regulatory structure that currently governs the financial services system. Thus, while we stated at the outset that CBA would analyze the issues presented in this hearing from a public policy perspective rather than from the viewpoint of its own parochial interests, CBA believes it is important to point out at this juncture that the competitive inequities created by this regulatory structure seem to weigh decidedly against the banks. While we as banks, of course, have our own -- perhaps parochial -- concerns about this impact, we would earnestly suggest that our concerns should be shared by any who believe in the need for a strong banking system. These competitive inequities and the chaos and confusion created in the marketplace by the current regulatory structure were well documented in July 1983 hearings before a House Government Operations subcommittee on the legal framework of the American financial services industry.

By way of example, only banks seem to be limited to narrowly defined products and services, while other financial services providers are permitted to diversify into all of the financial services sectors, irrespective of the fact that they also are offering bank or bank-like products. Securities firms can offer deposit instruments -- often with transactional capabilities -- through deposit brokering or mutual funds or by way of deposit-like accounts such as money market mutual funds, make commercial and consumer loans, provide cash management services and engage in fiduciary-type activities. Moreover, all of these bank and bank-like services may be combined with a full range of securities brokerage, underwriting and distribution activities. Similarly, insurance firms, which are even more bank-like in their role as financial intermediaries, may offer a full array of other financial services.

In addition, these securities and insurance firms are not limited to performing activities that traditionally fall within their own individual sectors. These entities are permitted to cut across all other product and sector lines and engage in activities traditionally within the realm of all of the other sectors. Securities firms may engage in real estate, insurance, and other financial services activities and insurance firms may engage in securities, real estate, lending and other financial-type activities.

The competitive inequities do not stop there. These financial services providers also have been permitted to acquire banks and other depository institutions generally without legal obstruction. While significant regulatory and judicial obstacles now prevent bank holding company utilization of the so-called nonbank bank for expansion purposes, other financial services providers continue to expand into banking through the use of this vehicle. Just last month, another major retailer, Montgomery Ward, joined the parade of diversified financial services firms that have acquired commercial banks. While the existing regulatory structure does not seem to prevent others from pursuing symbiotic and profitable financial services options, the competitive inequities in the system have prevented the banking industry from doing likewise and, thus, have played a substantial role in the profitability losses, bank failures and general safety and soundness concerns that are plaguing the banking industry.

CBA believes that the above evidence demonstrates that the current system of legal constraints and forced specialization has played a part in jeopardizing the safety and soundness of the banking industry rather than promoting it. Both its liability products and its commercial and consumer credit products are being co-opted by nontraditional financial services providers, thereby exposing the industry to increased exposure and possible instability. In short, it is no longer reasonable to merely assert that the current regulatory regime must be retained in order to assure safety and soundness of the financial system. In this regard, the current regulatory framework fails to follow the first of the principles enunciated above.

2. *The current regulatory system stifles competition, depriving consumers of convenience, choice and best price.* Not only can the current regulatory system no longer be said to guarantee a safe and sound financial system, but it also fails to meet important consumer objectives. An excellent example of this failure is the degree to which current laws proscribe or severely discourage the entry of new financial competitors. Decreased competition clearly harms consumers. Foreclosed entry of traditional banking institutions into other financial services areas and similar hindrances to entry of other financial services providers into traditional banking can only have a negative impact upon the marketplace. Under the current regime, market participants are not permitted to respond competitively and, thus, are not encouraged to innovate, develop and deliver products and services that respond to customer demand at competitive prices.

When competition is foreclosed as it is now, existing product and service distribution channels are protected, resulting in higher prices and restricted consumer options. A principal example is the excessive cost and inefficiency that exist in the current insurance distribution system. It has been estimated that the independent agency distribution system costs consumers approximately $1 billion more annually than is necessary, due in large part to the fact that expenses are

approximately 21 percent higher than when insurance is sold on a direct basis.[26] For the insurance industry as a whole, commissions as a percent of premium income vary by product, ranging from less than 9 percent for annuities to 19.4 percent for whole-life policies. In fact, the independent agent's commission on a whole-life insurance policy often is equivalent to the first year's premium. These statistics demonstrate that consumers are paying much more than is necessary in order to get the same insurance coverage that they could get if the number of market participants was expanded.

As two issues of *Consumer Reports* have indicated, consumers would benefit significantly if financial institutions were permitted to sell life insurance. One issue of *Consumer Reports* rated term insurance policies by their relative costs. The results showed that savings banks consistently offered the least expensive policies over periods of 5, 10, and 20 years. Significantly, in every case, savings banks yielded below the median 10-year interest-adjusted net cost index. In fact, in five out of six instances studied and out of a range of 177 insurance company offerings, a savings bank offered the best buy. For example, New York Savings Bank yielded a 1.29 cost index to 25 year old females, while the median cost of such a policy is 2.13. Similarly, a 45 year old male can obtain this policy with a cost index of 3.32 from Massachusetts Savings Bank, while the average cost elsewhere is 5.58.[27] The reason savings banks such as these can offer such low cost insurance is due to the fact that no "middleman" is involved when banks sell insurance directly.

A similar survey of whole life insurance also was conducted by *Consumer Reports*. Again, the survey found that banks offer the best buys in insurance. Savings banks' whole life policies were found to be among the least expensive over 5, 10 and 20 year periods and, out of the 30 life insurance offerers that participated in the survey -- only two of which were savings banks -- one of the savings banks offered the least costly policy across the board for 25, 35 and 45 year old males and females. Moreover, savings banks yielded below the median 20-year net cost index in 11 out of the 12 instances studied. This survey also found that savings banks offered the highest rates of return after 10 and 20 years.[28]

Another specific example of the cost savings potential is provided by a bank whose early insurance activities have been grandfathered. Appendix B reflects that bank's rates and those of four other insurance companies for two types of automobile insurance policies, broken down by the geographical areas of the State of Maryland. Of the 74 comparisons, the bank offered equal or lower premiums in 54 cases -- 73 percent of the time.

These cost reductions would be available to consumers for several reasons. Banks could utilize their branch networks and their existing electronic distribution systems to deliver insurance products. Excess capacity and existing staff also could be used to sell and service insurance policies. Some estimates indicate that bank sale and delivery of insurance would cut insurance costs by about one-third. By conservative estimates, distribution costs could be reduced, on average, from 15 cents to 25 cents of every premium dollar, saving consumers $50 a year on a $500 auto policy. Under the current regulatory structure, these cost savings are not being made available to consumers.

By not removing the artificial barriers that separate traditional banking and insurance products, banks are not able to offer insurance through bank distribution systems which could be offered at minimal incremental cost. On the other hand, insurance agents are being prevented from spreading their costs over a broader array of services through the offering of banking products. The constraints on banking and insurance services providers that result from the current artificial regulatory barriers decrease consumers' bargaining power and prevent product innovation and modernization.

In addition to discouraging competition, the current system thwarts consumer convenience by preventing them from having access to a full array of financial products from a single provider. As noted on page 12, consumers overwhelmingly want to have this convenience. In order to respond to that need, one-stop shopping for naturally synergistic banking, securities and insurance products should become the norm, rather than the exception. All financial services providers, including banks, should be permitted to develop and integrate diverse forms of financial services into combined products and, thereby, provide a full array of products and services so that one-stop shopping can become a reality. Only then is the financial services industry providing the products and services that fulfill consumer's needs conveniently and at the lowest possible price.

Today, with the possible exception of a single major retailer -- Sears -- there is no one financial services provider that is in a position to provide consumers with this type of choice and convenience. While totally unregulated financial planners may advise consumers on the best array of financial products to meet their needs, no one financial services provider can supply that full array. The regulatory structure should not be permitted to frustrate the ability of the financial services industry as a whole to provide consumers with that option.

In short, the current regulatory system discourages competition and actively prevents financial services providers from meeting consumer needs. Thus, that system utterly fails to meet the consumer benefit principle set forth above.

3. The existing regulatory system does not facilitate an efficient, cost-effective financial services industry. Today's artificially fragmented regulatory scheme provides a third instance of failure to meet CBA's guiding principles. While the lines of distinction among the various sectors of the financial services industry are becoming increasingly vague, many of the inroads made into other sectors are the result of innovations that are neither efficient nor cost-effective. Maintaining traditional and outmoded barriers without regard to their impediment of the rational provision of desireable products and services only perpetuates market inefficiencies which, necessarily, increase consumer costs.

To some degree, each segment of the financial services industry seems to be providing products and services that are similar to those that historically have been within the domain of one of the other sectors. However, in many cases these products and services are competitively replicated only after untold resources are expended in devising costly, complex and inefficient strategies which conform to the existing regulatory structure. All of these time-consuming and expensive gymnastics are pursued for only one purpose -- to meet consumer needs and demands. These contortions in response to market demands do not boast of any socially or economically redeeming value other than to demonstrate once again that market forces inevitably stimulate the level of ingenuity necessary to satisfy arbitrary and outmoded limitations.

Numerous examples may be cited of this blurring of industry lines and the inefficiencies that are encouraged by the incongruance of market demands and present public policies. Money market funds and cash management accounts that are offered by the securities industry certainly are at the very least bank-like products. Partly in response to that phenomenon, banks devised the automatic transfer account or ATS account to provide consumers with a market rate on their transaction accounts. The ATS account is a good example of one of the earlier inefficient responses developed by the banking industry to respond to marketplace events and meet consumer needs it could not address directly.

Another example of this blurring of distinctions is the nonbank bank and the unitary savings and loan holding company. Nonbank bank ownership by entities engaged in activities not permitted for bank holding companies and the unitary savings and loan holding company are exceptions to the supposedly carefully maintained separation between banking and general commerce.

Every day banks are joining with securities firms in order to provide indirectly a greater array of investment services to their customers. For example, banks "make available" to their customers mutual funds that are underwritten and distributed by the mutual fund industry. Under this scenario, among other things, most banks believe it is necessary to send their customers to a third party -- namely, a member of the securities industry -- to get a prospectus on the fund. This inconvenient and inefficient step is believed to be necessary in order not to run afoul of the Glass-Steagall Act.

Similarly, since they are not permitted to sell most forms of insurance directly to their customers, more and more banks are meeting at least some of the insurance needs of their customers by permitting insurance companies to distribute insurance on bank premises in exchange for a percent-of-profits lease arrangement or by selling their customer lists to insurance companies. Once again, pursuing indirectly opportunities which can not be undertaken directly is fraught with inefficiencies.

Only by eliminating the outmoded legal barriers that force the use of these exotic and inefficient mechanisms -- and, thus, permitting all financial services providers to provide directly and efficiently those products and services that now are being provided indirectly or not at all -- will consumers be provided with a full array of products and services conveniently and efficiently.

Financial services regulation should permit banks to provide insurance, securities and other financial services products. Likewise, securities, insurance and other financial services firms should be permitted to provide bank products.

Despite the obvious efficacy of this approach, which recognizes today's market realities, the banking industry is now being prevented from providing consumers with efficient, cost-effective products and services. One of the inevitable by-products of the current regulatory regime is the chaos and confusion that results from a heavily regulated banking industry attempting to follow an obsolete legal framework in a rapidly evolving financial system.

Increasingly, as banks try to follow their traditional areas of business into the changing financial products being demanded by today's market, they subject themselves to protracted and expensive litigation. As one example, in January 1979, a major commercial bank was challenged in performing the now common activity of privately placing commercial paper. More than five and one-half years later, the United States Supreme Court determined merely a threshold question by deciding that commercial paper was a security under the Glass-Steagall Act. The controversy over the permissibility of this activity continues, having worked its way back down through the court system to the federal regulatory agencies, back into the trial court and now up to a federal appellate court. Thus, this issue, not yet resolved, literally may take years and millions of dollars to lay to rest.

Business by litigation creates uncertainties and obvious inefficiencies. In addition to the direct costs occasioned by litigation, there are untold costs in terms of discouraged innovation, inability to plan and develop sound business strategies and added confusion as to what products can be developed and marketed and even how and where they actually can be offered.

One example of that confusion involves the totally appropriate and arguably legal activity of national bank sponsorship and underwriting of shares of mutual funds that consist wholly of bank permissible securities. In 1983, the Comptroller of the Currency issued a banking bulletin authorizing national banks to purchase, for their own accounts, shares of open end investment companies that consist solely of securities that are eligible for direct purchase by national banks -- namely, bank eligible securities. The law with respect to bank eligible securities, as implemented by the Comptroller, permits national banks to underwrite so-called Type I and Type II securities, as well as to purchase and sell them for their own accounts. Thus, if national banks are permitted to indirectly purchase such bank eligible securities for their own accounts through the purchase of investment company shares, they also should be permitted to indirectly underwrite bank eligible securities through the operation and underwriting of shares of investment companies that consist solely of such securities. In other words, the risks and legal analyses are virtually identical. Yet despite the apparent availability of this totally appropriate activity, to our knowledge no bank has yet attempted to undertake this activity. That reluctance can only be based on the certain knowledge that to do so would trigger long, expensive litigation.

Clearly, the current financial regulatory framework fails to allow for the availability of an efficient financial system for consumers.

4. *The current regulatory system is inflexible*. The existing regulatory system is unable to respond to the substantial changes in the marketplace discussed above. It lacks the flexibility needed to allow regulation to grow with and adapt to changes in the market and, instead, stifles the ability of regulated participants to respond to those changes.

One example involves the increasingly anachronistic distinction in regulatory treatment between municipal bonds that are backed by the general obligation of a governmental entity and those that are funded only from dedicated revenues. When this restriction was originally adopted, banks were authorized to engage in the underwriting and distribution of the type of municipal bonds then being utilized -- general obligation bonds. When the Glass-Steagall Act was adopted, municipal revenue bonds were virtually nonexistent. That has changed dramatically over the past several decades. This rapid change in the method of funding local activities has made revenue bonds the preeminent form of municipal finance. In 1985, revenue bonds accounted for 73 percent of the overall municipal market while the much smaller general obligation bond segment has declined considerably and continues to decline.[29] Despite this major shift,

however, banks are still prohibited from underwriting and distributing anything but general obligation bonds.

There are other examples of the harmful effects of inflexible laws. As described above in connection with innovative deposit products, when interest rates increased, depository institutions were faced with virtually unprecedented disintermediation. By prohibiting depositories from offering a competitive account, the regulatory system was unable to respond to market changes. Only after substantial erosion of consumer deposits and even then only after the delays incumbent in any legislative response were the statutes changed to permit a reasonable response to market changes.

Thus, the regulatory system either has failed to take into account the continued evolution of the financial services industry or has involved such delays in responding that injury has been done to narrowly restricted services providers. Having an orientation in the consumer credit area, we are familiar with past successful Congressional efforts at anticipating future change. In the Electronic Fund Transfer Act, for instance, which was adopted before widespread use of electronic payments, the Federal Reserve Board was specifically encouraged in adopting and amending its implementing regulations to anticipate and respond to technological and market changes. For example, in Section 904, the Board was directed to "take into account and allow for the continuing evolution of electronic banking services and the technology utilized in such services."[30]

Regrettably, a similar theme is no where to be found in the more fundamental statutes that mold the form of today's financial services industry. CBA believes, however, that the flexibility that was proposed in a number of Senate measures last session is the type of flexibility that should be contained in the laws that govern the very structure of this industry. In proposed amendments to the Bank Holding Company Act, those Senate measures would have permitted the Federal Reserve Board to authorize not only activities that are closely related to banking -- the current standard -- but also activities of a "financial nature" (1) that are designed to enable bank holding companies to adjust to technological innovations or (2) that are substantially identical to products or services offered by nonbanking concerns that are competitive with those offered by banks.

The current restrictive legal structure simply does not permit the regulatory flexibility necessary to accommodate the changes being experienced in the financial services industry.

Regulatory changes are needed now. CBA believes it has demonstrated in vivid and disquieting detail the fact that the industry structure as mandated by current law does not further the public policy goals that should be served by the laws. In fact, the evidence regarding other industries that are not similarly constrained and that are free to take advantage of the directions in which the marketplace is moving, illustrates that modernization of the laws to permit banks to diversify into other financial services arenas would be fully consistent with the principles listed above.

While awaiting modernization, however, the costs created by Congressional delay are real. The current regulatory structure and the absence of Congressional action are creating systemic risks that CBA believes no longer can be safely ignored. The existing asymmetry between regulation and the marketplace gives rise to problems in terms of costs, inefficiencies, uncertainties and an increase in the vulnerability of the safety and soundness of the banking system that all parties profess that they want to avoid.

Thus, dramatic changes must be made and they must be made now. In analyzing those changes and the inevitable resistance to them, however, it is critical to dispell the wrong-headed notion that suggestions for change must be contrasted against our existing convenient, efficient, safe and sound financial system. Nothing can be further from the truth. Rather, the potential for adverse effects that might accompany any reform must be realistically balanced against the existing relatively inconvenient, inefficient and increasingly less solid financial system that continues to erode even further due to Congressional stalemate and neglect.

III. A Proposal For Reform

Having discussed the need for change and the urgency of addressing the issue now, CBA would respectfully like to propose the framework of a program that would reflect the necessary changes.

CBA suggests that all participants in the financial services industry, including banks (which for purposes of CBA's proposal includes thrifts as well as commercial banks), should be permitted to be involved in the full range of banking, insurance, securities and other financial services activities. However, since one of the most critical questions in evaluating safety and soundness and related public policy concerns with respect to traditional banking activities is one of risk, CBA proposes a rational method of dealing with those risks.

A number of industry groups have surfaced, and the Association of Bank Holding Companies in particular is refining, the concept of a financial services holding company as an umbrella organization controlling subsidiary companies engaged in the full range of financial services activities. Each of these subsidiary organizations and their respective lines of business would be functionally regulated and appropriate limitations on affiliate relations and dealings would safeguard the integrity of each of the subsidiary companies. CBA supports the financial services holding company concept developed by the Association of Bank Holding Companies, particularly as described in its January, 1987 testimony before the Senate Banking Committee.

Of course, this suggested framework for modernization of the financial services industry is intended to operate reciprocally since CBA also believes that the modernization and restructuring of the system should promote parity among all financial services providers.* Thus, if banks are permitted to undertake certain new activities directly in the bank, then companies that are engaged in only those activities should be permitted to apply for and acquire a bank charter. In other words, such companies would be permitted to perform traditional banking activities only if they first become chartered asbanks. Similarly, if other activities are authorized only if they are undertaken through the bank holding company structure, companies that are engaged in those activities should be authorized to become bank holding companies by acquiring banks.

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* Parity also forms the basis for CBA's views on the payment system issue. CBA believes that the policies, principles and goals that form the backbone of this analysis also should be applied to the ongoing debate about the payment system. We believe that the September, 1986 testimony of Under Secretary of the Treasury Gould before the House Subcommittee on Commerce, Consumer & Monetary Affairs constitutes an excellent discussion of the issues that surround the payment system debate.

As indicated at the outset, as a general matter we believe that all aspects of the foregoing discussion should pertain to thrifts, as well as banks. Thus, the activities that are authorized for banks also should be authorized for thrifts. However, if the Congress should make a public policy determination that thrifts should continue to serve principally the housing sector, then additional incentives may be necessary to permit thrifts to operate on an equal footing with the rest of the industry. In fact, the diversification that is being recommended for the banking industry as a whole will be particularly important for the thrift industry if thrifts are required to maintain a specific percentage of their assets in the housing market. This equalization of treatment also eventually would require that the standards that govern the thrift industry -- such as accounting and capital standards -- be the same as those that apply to banks.

CBA now has described a proposed framework for reform of the legal system that governs the financial services industry. Only after the Congress has come to grips with the issue of whether to permit the structure of the industry to accommodate the current marketplace and meet the needs of this age, should the Congress then turn to the very important question of regulatory supervision and oversight of that new structure. The much-heralded concept of functional regulation should be considered only after Congress has devised a system that might necessitate, and even benefit from, such a concept.*

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* As with those that it supervises, we would like to point out that the securities industry regulator has not seen fit to await Congressional adoption of the functional regulation approach. In justifying its new assertion of jurisdiction over commercial banks, the Securities and Exchange Commission cited as one basis the recent enthusiasm for functional regulation. *See* Release Accompanying Rule 3b-9, 50 *Fed. Reg*. 28385, 28387 n.19 (Friday, July 12, 1985)(citing *inter alia*, the statement of John S.R. Shad, Chairman, Securities and Exchange Commission).

While the idea of functional regulation seems appealing, at least to the extent that a new financial services activity that traditionally has been within the securities or insurance sectors is undertaken through a holding company or other affiliate, CBA believes that it would be "putting the cart before the horse" to deal with regulatory and supervisory issues prior to addressing the basic structural issues. Nonetheless, CBA believes as a threshold matter that it may well be appropriate where new activities are performed in an entity that is separate from the depository institution itself, such as through a holding company affiliate. In that circumstance, it may be appropriate for supervision and oversight to be performed by the regulator that traditionally has regulated the industry sector that historically performed the activities in question. For example, if insurance underwriting were required to be performed through a separate affiliate, then state insurance departments may be the appropriate supervisory authorities for that activity. To reiterate, however, CBA believes that functional regulation is of highly questionable appropriateness when activities are undertaken directly by a depository institution.

IV. The Proposed Structure Would Advance The Principles Outlined At The Outset

The regulatory system suggested by CBA would satisfy all of the goals and objectives identified at the beginning of our analysis. The proposed restructuring of the financial services system would not jeopardize and, in fact, would enhance the satisfaction of those principles. Our proposal fully satisfies those six principles and, thus, we will not retrace them one-by-one. Instead, we will identify and explore the four factors that are cited most often as reasons for avoiding change: (1) the impact on safety and soundness; (2) the potential for conflicts of interest; (3) the potential for tying of services; and (4) the possibility of improper concentration of resources.

Such a modernized system would NOT jeopardize the safety and soundness of the banking industry. Diversification would promote safety and soundness. In fact, as it has been amply demonstrated by the statistics on problem banks cited above on page 20, forced specialization and an absence of diversification have contributed substantially to the current problems being experienced by certain sectors of the banking industry.

One recent analyst made clear that increased diversification would, in fact, reduce banking risks. Proving what often has been assumed, he found:

> . . . most bank failures can be traced to bad management or narrowly defined banking activities. Almost every bank failure in recent years involved bad credit judgment, often compounded by excessive reliance on a short-term purchase fund position. The remaining bank failures have generally been attributed to dishonesty and fraud . . . .[31]

Even the banking industry's function of meeting the credit needs of narrow and often financially troubled sectors would not be so detrimental to the safety and soundness of the banking industry if banks also could offer an array of fee-based products and services that do not place bank assets at risk. However, the inability to diversify into such areas and the forced specialization in lending, have led to safety and soundness concerns at many banks.

Insofar as limited diversification has been permitted -- although, as in this case, only after extensive and expensive litigation -- it has demonstrated its benefits to the health of the depository financial system. Bank of America is a good case in point. It is well known that the declining profits at Bank of America Corporation have been attributed to the bank portion of the holding company, while the discount brokerage affiliate has been the holding company's main profit center. The company's sagging fortunes have been attributed directly to loan losses -- such losses totalled $382 million in a single quarter in 1985 -- and an even more troublesome picture has been avoided only because its affiliates have boasted substantial gains.[32] Its Capital Market Group experienced a 160 percent growth in revenue from 1979 to 1984. Charles E. Schwab & Co., the bank's discount brokerage affiliate, earned $3 million in 1984 and was on its way to a $20-25 million year at mid-1985.[33] A national business weekly noted that "[b]uying Schwab may be the best thing Bank of America has done in ages."[34]

Thus, as a fundamental proposition, diversification has been demonstrated to be a positive contributor to the strength of depository institution holding companies. Accordingly, new powers and authorities are not inconsistent with the goal of safety and soundness. Instead, diversification would promote a safe and sound system. The ability to increase economies of scope (that is, economies that accompany not size but rather the offering of a broader range of products and services) clearly would be beneficial to the strength of the banking system and at the same time would increase consumer convenience by allowing consumers to select a full range of products from a single vendor.

Fee income is becoming increasingly important in off-setting the loss of interest income and, thus, in shoring up depository institutions' deteriorating position in the financial marketplace. For example, from 1982 to 1983, the operating income of insured banks in the United States declined by approximately 7 percent. During the same period, their income from service charges, commissions and fees increased by more than 17 percent.[35] Although the dollar value of these items was small in relation to the banks' total income, it could be expected to be a significantly greater portion if banks were permitted to diversify into financial services areas that generate fee-based income. Such a new source of income certainly would contribute to the safety and soundness of the banking system.

Troublesome conflicts of interest would not arise. In many respects, conflicts of interest are inherent whenever a number of different products are offered by one provider. As stated by another commentator:

> Conflicts of interest are a way of life; the dentist who is considering whether to pull or polish your tooth is facing a conflict. The doctor who is considering whether to prescribe pills and send you home or to operate is facing a conflict. The issue is not how to eliminate conflicts; that would scarcely be possible, but the issue is what sort of conflicts should be absolutely prohibited and what sort of conflicts must be tolerated in the larger social interest.[36]

It is simply unrealistic to suggest that we can guarantee that there will be *no* conflicts of interest when many different financial services and products are being offered. That conflicts are an inevitable part of a complex society, however, does not end the inquiry.

Clearly, conflicts of interest exist within every segment of the financial services industry today. An insurance agent faced with a variety of products obviously faces varying compensation implications. For instance, commissions and benefits to the individual agent will vary based on differences in products -- a whole life policy, a term life policy, an annuity -- and differences in companies providing the products. Likewise, securities activities raise numerous potential conflicts of interest. Conflicts are presented when a securities firm is a market maker in securities, offers new issuances, serves as a broker, provides investment advisory services and offers a variety of financial products including mutual funds and unit investment trusts. Here, too, the commission structure and the institutional implications present inevitable conflicts of interest.

Thus, the fact that there will be conflicts of interest simply cannot serve as a sufficient basis for determining that new activities should not be undertaken. Rather, the true inquiry -- as it now exists in each of the separate segments of the financial services industry today and as it will exist in the future with an expanded array of financial products that may be offered by all financial services providers -- is whether the conflicts of interest can be dealt with adequately to protect the public.

For example, in the securities area this is handled by a strict set of rules and regulations as to how securities firms deal with the public. These precautions include extensive disclosure requirements and various "Chinese Wall" restrictions that impose an intracorporate separation among the various activities that could give rise to conflicts. Banks are very familiar with, and have an outstanding record in observing, "Chinese Wall" principles in the separation of bank trust and commercial operations. CBA would expect that those same rules and regulations that now apply to the securities industry also would apply to financial institutions that are engaged in securities activities.

Again, it should be emphasized that the mere suggestion of the possibility of a conflict of interest is not the end of the inquiry. All financial services areas *now* present these conflicts yet -- within their respective segments -- there is very little suggestion of inappropriate activity. In all of these areas, the issues become: Can the conflict be rationally and reasonably controlled and managed? Further, do the advantages to the public of combining these various products and services outweigh any vestiges of conflict that might remain?

First, as demonstrated by current regulation on an industry segment basis, conflicts can be controlled and managed. The creation and success of Section 23A and "Chinese Walls," as described earlier, provide clear evidence that these conflicts as with compliance matters more generally can be adequately managed and regulated. Second, the marginal possible increase in potential conflicts of interest cannot be said to offset the consumer benefits from having a broader array of financial products being made available by a larger number of providers. In fact, insofar as current regulation restricts product choices, true conflicts seem more likely -- if the provider is not allowed to sell the product the consumer *really* needs, it will sell him or her something that is "close." That structural conflict of interest created by the current regulatory system poses far greater risks than the slight possibility that permitting more people to sell more products will somehow exacerbate conflicts of interest.

Tie-ins will not occur. The marketplace today is not conducive to tying, although the current segmentation of that market makes tying *more* and not less likely.

It is a fundamental premise of the theory of tying that some degree of monopoly power has to exist if a company is to tie one product, such as the sale of insurance (the tied good), to another product, such as an extension of credit (the tying good). Both explicit and implicit tying depends in large part upon significant monopoly power. Such monopoly power does not exist with respect to any of the individual segments of the financial services industry today, not to mention the financial services industry as a combined group. Insofar as the potential for tying currently exists, it is a result of exclusive franchises having been granted to only one sector of the industry, thereby positioning it to take advantage of the niche guaranteed by federal regulation.

If existing barriers were removed and each of the various industry segments were permitted to offer the types of products and services now permitted only to other industry segments, the chances of monopoly power would be reduced further.

To the extent that there is potential in the marketplace for either explicit or implicit tying, existing provisions in both the Bank Holding Company Act and the antitrust laws are adequate to police and remedy tie-in practices. In particular, the treble damage provision that is available under the Bank Holding Company Act to consumers who bring actions for tie-ins provides a most effective deterrent.

Whether it is due to the lack of monopoly power in the marketplace or the effectiveness of the anti-tying laws, the studies and consumer attitudinal surveys that have been undertaken with respect to the tying of credit and insurance products have determined that there is very little incidence of either explicit or implicit tie-ins. The most comprehensive study in this area, which was conducted by the staff of the Federal Reserve Board in 1979, concluded that explicit tying between the granting of credit and the sale of credit-related insurance products was "practically nonexistent" and implicit pressures were "neither very strong or widespread in the industry."[37] A more recent survey conducted by the Federal Reserve Board staff in late 1985 provided additional and more current substantiation for this conclusion.

Of particular significance to this debate is the fact that the Board's 1985 study found that consumers in deciding whether to buy credit insurance overwhelmingly did not believe that their decisions affected the credit decision.

> To gain further insight into the question of whether borrowers were subjected to "undue" pressure by creditors to purchase insurance, each respondent was asked whether they felt their decision to purchase credit insurance made a difference in whether the creditor would grant the loan. In 1985, both borrowers with credit insurance, as well as those without it, held similar views. Overwhelmingly (approximately 95 percent), borrowers in 1985 stated that they believed taking credit insurance would not make any difference in whether the lender would grant the loan . . . . These results suggest most consumers did not feel pressured by lenders into purchasing credit insurance as a condition for obtaining the credit.[38]

Thus, it is absolutely clear that with respect to the one product that banks now could "tie" to credit extensions, the most important person -- the consumer -- is saying that they are not engaging in tying practices.

This conclusion also is supported by indirect analysis. With respect to credit-related insurance penetration rates, the Federal Reserve Board's 1979 study found significantly lower rates of penetration than would be expected if tying were a wide-spread practice in the banking industry. The median penetration rates for property and casualty insurance were found to be well below 40 percent.[39] In surveys by the Federal Reserve Board in 1977 and 1985, approximately 63.9 percent and 64.7 percent, respectively, of the borrowers surveyed indicated that they had purchased insurance in connection with the credit transaction.[40] Reviewing the 1977 statistics, the Board concluded in its 1979 study that such a penetration rate was not suggestive of wide-spread, explicit tying.[41] In fact, based on the complete absence of complaints with respect to tying and the results of attitudinal surveys, the Federal Reserve Board's final conclusion in 1979 was that these penetration rates "do not . . . appear to have resulted from either explicit coercion or involuntary tying."[42]

State insurance department records show absolutely no complaints alleging coercion by banks in selling insurance, while at the same time they average 30 complaints a month involving insurance agent and broker practices.[43] This result was confirmed by an earlier survey of insurance departments in all 50 states that was conducted by the National Association of Insurance Commissioners. The survey showed that of the approximately 130 complaints concerning credit insurance that were filed each year, only 0.7 percent (or about two a year) involved alleged coercion of debtors.[44] The Federal Reserve Board's 1979 survey that included a canvassing of the complaint files of the Federal Reserve System also supported these results. Between 1970 and 1979 absolutely no complaints had been filed by either businesses or consumers alleging violations of the anti-tying provisions of the Bank Holding Company Act.[45]

The Federal Reserve Board's *1977 Consumer Credit Survey* also demonstrated the absence of widespread coercion in the fact that 74.8 percent of the consumers who responded to the survey did not believe that insurance was either "required" or even "strongly recommended."[46] The 1985 survey confirms this finding and indicates that using an average of families both with and without credit insurance, over 89 percent fell into that category. The Federal Reserve Board concluded that these statistics indicated very little incidence of tying since it would be unlikely that the illegal incidence of required credit insurance would be greater than, or even equal to, the perception that insurance is required.[47]

The absence of coercion also is demonstrated by the extremely high approval rating that credit insurance consistently receives from those who have purchased credit insurance. Of those responding to the Federal Reserve Board's *1977 Consumer Credit Survey*, 84.8 percent thought that credit insurance was a good product.[48] By 1985, this figure had increased to 92.8 percent.[49] This customer reaction is further supported by the *Ohio University Study* which found widespread satisfaction with credit life and disability insurance. In that survey, 90 percent of those purchasing insurance responded that they would purchase insurance again and the same percentage indicated that they would recommend insurance to others who are applying for a loan.[50] The Federal Reserve Board has concluded, on the basis of survey results, that the high proportion of customers expressing approval of credit insurance "supports the argument that the vast majority of insurance sales are made by the lender because the borrower finds that purchasing insurance from the lender is the most convenient and cost-effective way to obtain the service."[51]

The Federal Reserve Board also surveyed the practices of bank holding companies with respect to offering insurance. The Board found that the

> patterns of conduct and organization of sale of credit life and property and casualty insurance are not generally consistent with widespread tying. Respondents report that typically the loan is approved before the sale is attempted. In the case of mortgage redemption insurance, the solicitation is not usually made until several weeks after the loan has been disbursed. In addition, the majority of lenders indicated that the applicant is advised in writing that insurance is not required.[52]

Another study, prepared for the American Insurance Association by the nationally recognized accounting firm Coopers & Lybrand, reached conclusions and findings that were similar to those of various studies discussed above. This study was cited by The New York State Temporary Commission on Banking, Insurance and Financial Services, which concluded that current practices evidence minimal risk of coercive tying. The New York Commission then recommended that commercial banks, savings banks and savings and loan associations be authorized by statute to act as insurance agents and brokers for all types of insurance.[53]

The empirical evidence available on credit insurance sales made in conjunction with extensions of credit is exceedingly significant. Not only is it predictive of how other products would be fairly marketed by banks, it in many respects presents the "worst case" for the potential of tie-ins. Since tie-ins are not prevalent with respect to two integrally related products, it can be reasonably expected that consumers would be even less susceptible to coercion or tie-in pressures with respect to products that are not so closely linked. Thus, if anything, the available data overstate the possibility that tie-ins will develop with respect to products and services that are not so closely related.

Finally, the United States Department of Justice Antitrust Division has reviewed the potential for impermissible tie-ins should banks be given enhanced insurance sales authority. In commenting on a Federal Deposit Insurance Corporation proposed rulemaking regarding insurance activities of FDIC insured banks, in November of 1983, the DOJ stated:

> "Participation by banking organizations in a broader range of financial activities would be unlikely to result in a significant increase in anticompetitive tying arrangements. The offering of two services or products as a package may represent an economically efficient means of conducting business. Absent market power, a firm cannot restrain competition by such a

The CHAIRMAN. Thank you, sir.

Mr. Motley has joined us. You're the director of Federal legislation for the National Federation of Independent Business. Go right ahead, sir. You have 5 minutes.

STATEMENT OF JOHN J. MOTLEY III, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MOTLEY. Thank you very much.

On behalf of NFIB and its more than 500,000 members coast to coast, 45,000 of whom are in the financial services industry alone, I want to thank you for this opportunity to come here today and present our testimony on several financial services issues, but in particular on closing the nonbank bank loophole.

We certainly appreciate the opportunity and commend you, Mr. Chairman, for holding these hearings. I have a prepared statement which I would like to submit for the record.

The CHAIRMAN. Without objection, that will be printed in full in the record.

Mr. MOTLEY. Mr. Chairman, I also have a study which was done by NFIB and published in 1985 which is a third in a series of time sequence studies on credit, banks and small business from 1980-84, a study which a great deal of our testimony is based upon. I would like to submit that for the record.

The CHAIRMAN. We'd be happy to accept that for the record.

Mr. MOTLEY. Short of a comprehensive solution to the changes which are taking place in the financial industry of the United States today, Mr. Chairman, NFIB strongly supports the closing of the nonbank bank loophole.

We would much prefer to see the Congress take a great deal of time to study the trends that are taking place in the industry today, but realizing that that may not happen for a while, we strongly support what we believe is to be your intention and the intention of the chairman of the House Banking Committee to close the nonbank bank loophole.

SMALL BUSINESSES NEED OF CREDIT AND SERVICES

I think I should probably start by indicating that the reason that we are so interested in this is that, generally speaking, small businesses are heavy consumers of financial services and of credit. According to our study, at least half of NFIB's membership borrows frequently—frequently being defined by more than three times each year. There's a great deal of need for credit and financing in the small business community.

If you simply take a look at a retailer and the need to continually purchase and replenish inventory, they need a line of credit at the bank or they need financing to be able to meet these demands.

The vast majority of small business' financing tends to come from commercial banks. The reason for this is that small firms really don't go out and try to raise their funds in the equity markets, and they generally don't have a great deal of success of going to the other financial markets of the country. Most small firms simply do not have the expertise to be able to go out and to try to raise money through equity, and also the amounts of money they are looking for tend to be generally small. Those investors who provide equity financing are generally not interested in giving it to them.

There is also something very unique about most small business owners according to the surveying we have done over the years. Small business owners tend to be rather independent, and they really do not like to give away or to sell part of what they have developed to those people who are willing to invest the business. They like to keep as much of it for themselves.

Therefore, with this tremendous reliance upon the commercial banking community to raise financing, small businesses are tremendously concerned by the recent trend to move to interstate branch banking through the use of nonbank banks. We also find in the studies that we have that small businesses are tremendously reliant for their credit needs on generally small and medium-sized banks. In an interagency task force in 1982, 95 percent of the commercial loan portfolio of small banks went to small businesses. And, 77 percent of the portfolio for medium-sized banks went to small businesses, while only 13 percent of the commercial portfolios of larger money center banks went to smaller firms.

Small businesses are also very much pleased by the relationship that they have with their local banker. In times of need for example, during the recession of the early 1980's most small businesses were able to continue to get financing from the local bank that they have dealt with over the years at generally below market rates. They find out that the most important thing to them is the relationship they have built up with their banker and the banker's knowledge of the needs of their own particular businesses.

We are concerned about nonbank banks for two reasons. First of all is, we believe that it is a way to get around the Bank Holding Company Act and to establish interstate branch banking.

The CHAIRMAN. Mr. Motley, you are making a statement with which I agree wholeheartedly. It's a marvelous, brilliant statement, but your time is up. I hate to interrupt you. If you could finish in 30 seconds, we'd appreciate it.

Mr. MOTLEY. The reliance of small businesses upon local bankers is something that we believe is terribly important. Nonbank banks, we feel, threatens that relationship by possibly causing a concentration and also by reducing the number of available commercial loans. Therefore, we support closing the nonbank bank loophole.

[The complete prepared statement of John Motley III and a study of NFIB follow:]

> practice. Given the usual diversity of choices available to the financial services customer, it is generally unlikely that a particular provider of such services possesses the requisite market power to effect an anticompetitive tie. In any event, existing antitrust laws provide adequate protection against anticompetitive ties, whether undertaken by a banking organization, another type of supplier of financial services, or any other type of firm.54/

Thus, even those responsible for preventing these impermissible arrangements have recognized the lack of potential for tie-ins and the availability of existing regulatory tools to deal effectively with any tie-ins if they should arise.

CBA also believes that it is extremely important to focus on the distinction between tie-in sales that are illegal because they either explicitly or implicitly require customers to accept a product or service as a condition of getting another product or service and cross-selling which is both voluntary and legal. Cross-selling not only is voluntary but is beneficial to consumers since it assists consumers in the process of learning about, and being supplied with, a full array of financial services in a comprehensive package. In cross-selling, entities build upon existing customer relationships by cross-selling financially related products and services.

Undue concentration will not occur. The argument raised against bank entry into activities currently authorized only to the insurance and securities industries that such expansion will result in "undue concentration of economic resources" is the most specious of all, both as a matter of law and of public policy. In fact, unfettered entry into areas of financial services activity that previously have been reserved primarily for certain competitors would have the reverse result.

This can be demonstrated by looking at industry statistics that reflect significantly different levels of concentration. As detailed in Appendix C, the securities and life insurance industries are more than twice as concentrated as the commercial banking industry when considering the ten largest firms. Clearly, governmentally mandated specialization has generated increased concentration. Conversely, enabling competitors to diversify will reduce concentration.

At a more technical level, however, concentration can be analyzed meaningfully only in the context of one specific market. To the extent that the issue involves a product such as financial services that is in large part a local product -- that is, individuals may buy the product in a specific market -- and as long as there are numerous providers of those financial services -- that is, free entry into the market and an ability to compete -- undue concentration should not and as a matter of economic reality cannot -- exist. If one service provider in a specific market fails to meet customer demands -- either on the basis of convenience, price or quality of product or service -- then other providers in that market have the ability to erode the first service provider's market share.

One competitor may be able to prevail over another competitor in a specific market if the first competitor were able to dominate the market or if regulatory constraints proscribe the entry of the additional competitor into the market. However, some observers have claimed that domination can occur only if one of the competitors has an advantage due to economies of scale that would permit that competitor to undercut others in the marketplace. Those same observers also have documented the fact that banking operations generally do not benefit from economies of scale.55/ Moreover, domination is virtually impossible in most portions of the traditional consumer financial services area due to the exceedingly large number of credit service providers.

Thus, undue concentration in the financial marketplace is simply not a reasonable concern in considering the deregulation of products and services. In fact, as pointed out earlier, deregulation can only serve to enhance competition and, thus, decrease the spectre of undue concentration. In the highly unlikely event that market conditions subsequent to deregulation give rise to concentration concerns, the remedy lies in the antitrust laws that are crafted to deal with actual problems and not in the wholesale exclusion of competitors from large segments of an integrated product market.

Similarly, upon even cursory examination, undue concentration does not present a matter of concern in the consideration of geographic diversification and expansion. CBA recognizes that interstate banking and the branching and acquisition restrictions of the McFadden Act and Douglas Amendment are not the subject of this hearing. Nevertheless, we believe it is important to point out that the foregoing discussion regarding undue concentration applies with equal force to geographic expansion and the elimination of the artificial barriers that now prevent nationwide banking.

In fact, to the extent that concentration now exists in the banking industry, it can be credited to the barriers to entry that exist in the form of branching and interstate banking restrictions. Those restrictions are inherently anticompetitive and are the probable generators of such concentration as may exist in local markets -- the markets in which concentration must be measured.

Despite the tendency of current restrictions to increase concentration, however, even with that influence concentration has not been a great problem. Statistics have shown that at the national level, concentration has been declining steadily since the 1930's. The share of domestic deposits held by the 100 largest banks declined from 56.7 percent in 1934 to 45 percent in 1977.[56] The number of banks increased (net of mergers and failures) in every year but two between 1969 and 1980. During that period, the number of branches almost doubled, from 19,985 to 38,353, and the Herfindahl Index at the national level declined from 0.0061 to 0.052.[57] Clearly, if these restrictions were not in place, the concentration levels would be even lower.

As a result of changes in state laws, interstate banking is proceeding at a relatively rapid pace, albeit with a "balkanizing" effect. However, this interstate expansion is not giving rise to undue concentration or unacceptable industry consolidation. Virtually all of the interstate expansion has been through holding company acquisitions, thereby maintaining local institutions as local competitors in local markets. Thus, there is no evidence that undue concentration is occurring or is in any way imminent as a result of the piecemeal geographical deregulation that has taken place thus far. A recent study demonstrated this once more when it found that the ability of New York City banks to compete in upstate New York, did not result in undue concentration.[58] There also is no evidence that total geographic deregulation would result in undue concentration either. As with product and service deregulation, if marketplace occurrences subsequent to geographic deregulation -- be it at the state or federal level -- give rise to concentration concerns, the appropriate remedy at that time will be the antitrust laws.

V. Conclusion

Congress along with all segments of the financial services industry must work together in a good faith effort to establish a strong and viable banking and financial system that will serve today's individual and business consumers. It is beyond reasonable debate that the strict and artificial industry boundaries set more than 50 years ago have been overtaken by radical changes both with respect to the context in which existing restrictions are being applied and to the needs and expectations of the very consumers that those restrictions were supposed to serve.

CBA urges that we immediately begin to implement a rational and carefully considered analysis of the financial services regulatory system. We submit that a critical first step is to obtain a broad-based consensus on a comprehensive set of principles to guide any revision effort. CBA believes that, at a minimum, those principles should include the ones described herein. Once that task is complete, all parties will be better able to propose regulatory approaches that will assure the advancement of those principles. We believe that our analysis suggesting a procedure and a specific regulatory approach will advance this process.

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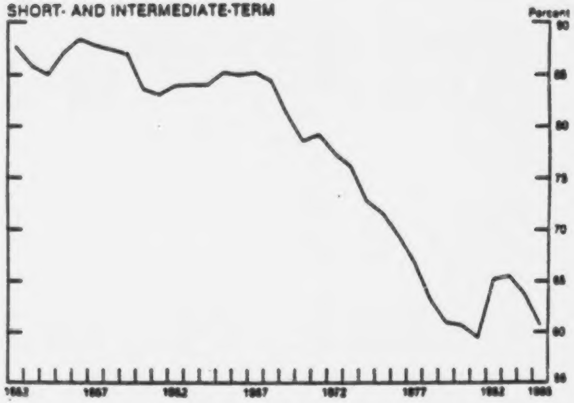
U.S. Banks' Share of Credit Extended to Domestic Nonfinancial Corporations



U.S. banks' holdings of nonmortgage loans and short-term paper issued by nonfinancial corporations as a share of nonfinancial corporations' total nonmortgage loans plus short-term paper outstanding.
Source: Flow of Funds.

APPENDIX B

MARYLAND AUTO PREMIUM COMPARISON - 2/1/85

	SUBURBAN/ RELIANCE	U.P. 10/84	GEICO 2/84*	STATE FARM 5/84*	ALLSTATE 4/84*
Territory 01 - Baltimore					
POLICY A	$ 365	$ 574	$ 545	$ 560	$ 764
POLICY B	1,135	1,152	979	1,080	1,366
Territory 02 - Baltimore Suburban					
POLICY A	415	422	390	454	486
POLICY B	812	826	679	872	864
Territory 08 - Montgomery County Outer Suburban					
POLICY A	391	482	374	434	452
POLICY B	732	898	635	828	788
Territory 09 - Prince Georges County Outer Suburban					
POLICY A	415	464	392	460	516
POLICY B	806	856	650	878	904
Territory 10 - Baltimore Outer Suburban					
POLICY A	365	372	362	456	486
POLICY B	713	726	616	866	864
Territory 11 - Montgomery County Suburban					
POLICY A	350	346	380	544	488
POLICY B	639	650	636	1,044	962
Territory 12 - Prince Georges County Suburban					
POLICY A	450	434	469	544	516
POLICY B	771	778	792	1,044	904
Territory 13 - Eastern Counties					
POLICY A	318	318	302	294	370
POLICY B	594	594	510	552	642
Territory 14 - Western Counties					
POLICY A	296	296	296	326	324
POLICY B	540	540	499	620	564
Territory 80 - Central Western					
POLICY A	296	336	NA	NA	NA
POLICY B	576	624	NA	NA	NA

* indicates date of last rate increase

Policy A = 1 Auto
Policy B = 2 Autos

APPENDIX C

COMPARATIVE INDUSTRY CONCENTRATIONS

10 LARGEST FIRMS' SHARE OF INDUSTRY TOTAL BASE

Concentration Rank	Industry	No. of Companies	Top 10 Share of Total Industry	Base	Total Base ($ Billions)
1.	Securities Industry	339	54.4%	Capital	$11.6
2.	Life Insurance Cos.	2,060	50.2%	Assets	$588.2
3.	P&C Insurance Cos.	2,953	34.5%	Assets	$251.2
4.	Savings Banks	424	29.5%	Assets	$174.2
5.	Commercial Banks	14,452	20.3%	Assets	$1,876.1
6.	Savings & Loans	3,342	13.1%	Assets	$686.2

Sources:

Life Insurance Fact Book
A.M. Best
NAMSB National Fact Book
FDIC
FHLBB

NFIB

STATEMENT OF
JOHN J. MOTLEY III

DIRECTOR OF FEDERAL LEGISLATION
NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	Committee on Banking, Housing, and Urban Affairs
Subject:	The Nonbank Bank Loophole and Small Business
Date:	January 23, 1987

The National Federation of Independent Business (NFIB), representing more than 500,000 small firms nationwide -- and more than 45,000 members in financial services alone -- appreciates the opportunity to present its views on nonbank banks to the Senate Committee on Banking, Housing, and Urban Affairs.

NFIB develops policy positions by polling our members throughout the year, both on national and state issues. We also publish periodic studies on selected topics such as taxes, banking, employee benefits, and the economy. Through the use of these materials, we have developed public policy positions which we feel accurately reflect the views and concerns of the small business community.

We favor the development of a comprehensive national banking policy to address changes taking place in the financial services industry. Central to such a policy must be a recognition of the

unique function banks perform as intermediaries between depositors and borrowers, a function that confers both duties and privileges. We advocate development of banking legislation to redefine the necessary distinctions between banking and other forms of commerce, and to restore the reasonable geographic restrictions imposed by the Bank Holding Company Act (BHCA). Banking reform legislation should also grant banks those new powers that are closely related to the business of banking, examples of which are the power to sell mortgage-backed securities and to underwrite and sell municipal revenue bonds. NFIB opposes allowing banks to enter the insurance and real estate fields, or other areas outside the traditional scope of banking services.

We are deeply concerned about two issues related to expanded power provisions. First, though it is forbidden by antitrust law, expanded powers may lead to so-called "tying" -- the implicit or explicit obligation of a bank customer to use one banking service to obtain another. Second, the question of maintaining bank safety and soundness is raised. Underwriting insurance in particular involves high levels of risk exposure not consistent with the prudence required in banking. Our membership has consistently, by margins of nearly four-to-one, opposed the idea of banks selling insurance and real estate. If the committee discusses new powers issues in the future, we would very much like to have the views of small business considered.

Short of obtaining comprehensive banking legislation, however, a single legislative goal stands out for small business: to close the nonbank bank loophole in the Bank Holding Company Act. For this reason NFIB commends the efforts of those Senators who desire swift and favorable congressional action to close the nonbank bank loophole. This testimony is intended to provide the committee with some background on small business banking needs, and to show how the proliferation of nonbank banks reduces financing opportunities for small firms.

America's small businesses are dependent upon commercial banks to meet their financing needs. Our time series data collected for NFIB's research and education foundation publication Credit, Banks and Small Business: 1980-84, published in March 1985, indicated that while new capital sources are developing, the vast majority of small business financing still comes from banks--usually small or medium-sized community-oriented banks. The reasons for this dependency are largely practical: small firms do not have the expertise to enter the equity markets for financing, nor is it economical for these firms to obtain small amounts of capital from these sources. In addition, small business owners, cautious and independent by nature, are reluctant to share ownership through equity financing. A poll of our membership in March of 1985 on this question found 65 percent opposed to banks taking a limited equity position in their business, with only 24 percent supporting shared ownership. Commercial bank loans, therefore, are a ready source of funds for small firms.

Confirming the data from NFIB's Credit, Banks study, an Interagency Task Force on Small Business Finance in 1982 discovered that 95% of the commercial loan portfolio at small banks and 77% of the commercial loan portfolio at medium-sized banks are loans to small firms. Thus, commercial banks are the best suppliers of capital to small businesses, and it is fair to say that small businesses are among the best customers of these banks. On the other hand, big banks do not substantially loan to small business. Small business represents only 13 percent of their total business loan capability.

In our biennial study, entitled Credit, Banks and Small Business, NFIB has also tried to measure the quality of small business banking relationships. We ask that our most recent study be included in the record in its entirety.

Each study has confirmed that the single most important element of a banking relationship for the small business owner is that the bank officer know the owner and his business--that is, personal attention is the most important ingredient to a successful banking relationship. This may explain further why small firms prefer to use small or medium-sized commercial banks. These institutions are usually located in small towns and rural communities and usually have a continuity of bank personnel and community presence that small firms value. In sum, small firms rely on commercial banks because they are able to obtain the short term and growth capital they need and because they can get the personal attention they desire.

The emergence of nonbank banks has very serious consequences for small business finance. As the committee is aware, a "nonbank bank" is an institution which purposely avoids the restrictions of the BHCA by performing only one of the two definitive functions of "banks" as described in the Act. Institutions that only take demand deposits or only make commercial loans are not "banks" for the purposes of the BHCA. By separating these two definitive functions, nonbank banks can operate outside the BHCA prohibition on interstate banking.

Small businesses have two major reasons for opposing nonbank banks. The first of these is that, as interstate banks, they threaten the stability of current small business banking relationships. In a very broad sense, small firms view geographic banking deregulation as a process that will allow big banks from the

cities to acquire or drive out of business small-town and rural banks, thereby concentrating bank resources. They expect that interstate bank branches will not provide the personal service they have been able to obtain from their community banks, and that loan decisions and bank profits will go to out-of-state bank headquarters. Whether conducted through full-service or nonbank banks, interstate banking means a decrease in community commitment and an end to permanent bank managerial personnel--vital features for small business banking relationships.

Greater concentration of banks may likely lead to a drop in entrepreneurial activity. Greater small business activity appears to exist where there is bank decentralization. The United States and Italy, both countries experiencing significant entrepreneurial activity, have a large number of commercial banks per capita. In 1982, there were 14,451 commercial banks in the U.S., or one bank for every 15,676 people; in Italy, there were 1,170 banks, or one for every 48,987 people. The data seem to indicate that countries with substantially lower entrepreneurial activity have greater bank concentration. France averaged one bank per 262,913 people and the United Kingdom had one for every 1,601,914.

While we have not demonstrated a causal relationship between bank decentralization and entrepreneurial activity, there is evidence that some relationship exists. Our contacts with small business associations in foreign countries, the United Kingdom, for example, reveals a deep concern about small business financing. From our conversations, we believe much of the concern can be related back to the concentration of banking.

Another reason that NFIB and its small business members oppose nonbank banks is that they are limited in purpose. Since nonbank banks can only take demand deposits or only make commerical loans (but not both), the traditional role of the commercial bank as an intermediary between depositors and commercial borrowers is ended by these hybrid institutions. The capital resources of a community are restricted, not circulated, by nonbank banks.

Roughly two-thirds of approved and pending nonbank banks are oriented toward serving the consumer market: that is, they will take only demand deposits and make only consumer loans. Unable to lend to small businesses (since their charters prohibit them from making commercial loans), these institutions will separate increasing shares of consumer deposits from use in the form of loans to small businesses. While the remaining third of nonbank banks will make only commercial loans, it is fair to assume that the greater portion of these loans will go to large concerns or high growth firms and not to mainstream small businesses. The advent of nonbank banks clearly means a significant reduction in financing opportunities for small firms--a trend we cannot tolerate.

In the 98th Congress, and again in the 99th, there was significant movement to close the nonbank bank loophole, and the consensus to accomplish this remains very strong. It is our hope that this committee will move swiftly to bring legislation to close the loophole through the committee process and to the floor. Likewise we intend to encourage the House to act quickly on legislation so that the development of the nonbank bank system can be halted.

NFIB believes that the basic objectives of our present banking policy are sound, though adjustments need to be made to reflect changes in the financial services industry. We view the objectives of that policy to be the furtherance of the social as well as economic potential of banking institutions. These include not only the safety of deposits, but also the worthwhile goal of circulating the capital assets of the community for commercial and consumer purposes. The separation of traditional deposit taking and granting commercial loans effected by nonbank banks cannot be anything but disastrous to small commercial interests. NFIB calls for closing the nonbank bank loophole (and debating full-service interstate banking on its own merits if we must). In the end, the free circulation of community capital will benefit banks, consumers, and small businesses without depriving any of a fair chance to compete.

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NFIB® CREDIT, BANKS AND SMALL BUSINESS: 1980-1984

MARCH 1985

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FOREWORD

Few institutions are more important to small business than the nation's commercial banking system. Few periods in the nation's financial history have experienced greater change or been more interesting than the late 70's and early 80's. As a result, what originally was planned as a cross-sectional snapshot of the relationship between credit and banks on the one hand and small business on the other has grown into a longitudinal effort, the termination point having yet to be determined.

Credit, Banks and Small Business: 1980-1984 is the second volume in the series. It differs from the first, Credit, Banks and Small Business, principally in that it incorporates data drawn from a 1984 update survey. This second volume, therefore, assesses data gathered in 1980, 1982, and 1984.

William C. Dunkelberg and Jonathan A. Scott are the authors of this volume, just as they were for the first

NFIB Research and
Education Foundation

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CREDIT, BANKS AND SMALL BUSINESS: 1980 - 1984

by

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EXECUTIVE SUMMARY

*Banks are overwhelmingly the primary source of credit for operating small businesses. No other source provides more than 5% of small business loans.

*While most firms borrow at one time or another during their business lives, the frequency of borrowing has declined substantially over the past five or six years as inflation has subsided.

*Neither the mean nor median loan size has changed appreciably over the past six years. Similar stability has characterized loan maturities.

*Few firms were "mismatched" in loan maturity and loan purpose. Almost all short-term loans were for short-term purposes, and almost all long-term loans were for long-term purposes.

*Collateral was used in over 60% of loan transactions. The larger the loan and the more risky the borrower, the greater the use of collateral.

*Lines of credit and variable interest rates have become increasing common.

*The spread between the prime rate and the average interest rate charged to small firms historically decreased when rates were rising and increased when rates were falling. This lag in the interest rate spread has recently been reduced due to greater use of variable rate lending.

*Credit is available in desired amounts to most operating small businesses most of the time. More than 85 percent had their latest loan request accepted, a figure which has not changed for all practical purposes over the past few years. Over 70% received the terms requested on their latest loan and 90% received the amount requested.

*Interest rates have increasingly become a sore point for smaller firms. This irritation has tracked the increase in real rates, not the decline in nominal rates.

*Small firms perceive increasingly greater bank competition, however the number of direct solicitations received for their bank business has declined significantly in the past ten years. The decline in solicitations is possibly a function of greater bank interest in the consumer credit market and the difficult economic conditions small business encountered in 1982 and 1983.

*Desired bank characteristics have changed little since 1980. By overwhelming margins, "Knows You and Your Business" is the most desired characteristic followed by "Reliable Source of Credit," and "Cheapest Money Available."

*Banks continued to receive highest performance marks on "Convenient Location," "Easy Access to Loan Offices," "Wide Range of Banking Services," and Reliable Source of Credit."

*As a general rule, the largest differences between evaluations of the desired characteristics of a bank relationship and actual bank performance occurred in those areas of greatest small business interest.

INTRODUCTION

This study reports on the third in a series of surveys conducted to monitor and help understand the relationship between small business and the financial markets. The focus of the study is the banking system, the major source of capital for small firms once they are established. The surveys were conducted in late March and early April of 1980, 1982 and 1984. There were 2,657 respondents to the 1980 survey (a response rate of 33 percent), 2,349 respondents to the 1982 survey (a 31 percent response rate) and 1,714 respondents in 1984 (a response rate of 25 percent).

Differing from the first report, this volume excludes any examination of the data by the type of banking regulatory structure prevailing in specific states. Changes in bank regulation have been pervasive in the past few years, making it difficult to identify the regulatory environment under which each loan was extended. As a result, the data related to regulatory structure have not yet been carefully assessed. When such analyses have been completed, findings will be presented elsewhere. However, to the extent possible, we hope they will be comparable in form to those findings presented in Credit, Banks and Small Business, published in 1983.

The National Federation of Independent Business has over 500,000 member firms. The composition of the membership is a reasonable representation of the small business sector of the U.S. economy[1/], a sector which produce over 40 percent of the private Gross National Product and employs well over half of the private non-farm workforce.[1/] The sample of firms used in each study was selected randomly from the membership file.

The studies were initiated during a period of turmoil in the financial markets. Recently deregulated, the markets were coping with the worst inflation and highest interest rates in recent history. The economy was entering the longest recessionary period since the 1930s, and monetary policy had shifted to a disinflationary course. The federal deficit was starting its drift toward new records, setting a pace that would double the trillion dollar debt in only five or six years. Thus, the three surveys cover what may be the most interesting period of financial history since the Crash.

I. SMALL BUSINESS BORROWING

A. Sources of Small Business Loans

The sources of capital used for starting a firm are substantially different from those used by a firm once its business operation has been established (Table 1). A 1979 study based on a large sample of small businesses indicated that about half of the firms were still owned by the entrepreneurs that had started them. Of the starters (in contrast to the purchasers, inheritors, etc.), 40 percent used only one major source of funds to start their firms. In 58 percent of those cases involving just one major source of funds, personal savings provided the capital. Institutional lenders were the major source of capital in only 18 percent of the starts with single capital sources. For firms with two major capital sources, institutional lenders were the predominant source in only twenty-five percent of the starts, and were the secondary source of funds for 45 percent of the starts.

Overall, personal savings played a major role in 63 percent of the new business starts. Institutional lenders, primarily banks, were important sources of capital in 47 percent of the cases. Friends and relatives were major suppliers of capital funds in 26 percent of all starts.

Once the firm has been established, its credit needs and its creditworthiness change. The emphasis shifts from personal sources of capital to institutional lenders. About 85 percent of loans to operating small businesses come from banks (Table 2). This has not changed since 1980 in spite of pervasive deregulation including the granting of new business lending powers to financial

Table 1

SOURCE OF FINANCING FOR SMALL BUSINESS STARTS[a]

One Major Capital Source	Percent
Personal Savings	23
Friends; Relatives	2
Institutional Lenders	7
Individual Investors	3
Venture Capital	☆
Government	1
Other Source	4
	40%
Two Major Sources[b]	
Personal Savings and:	
Institutional Lenders	23
Friends; Relatives	11
Individual Investors	2
Friends; Relatives and:	
Personal Savings	3
Institutional Lender	2
Institutional Lender and:	
Personal Savings	11
Friends; Relatives	3
	55%
Other Pattern; No Answer	5
TOTAL	100%

[a] Firms that were started by their owners, not purchased or inherited.

[b] Most important source listed first.

☆ Less than 0.5%

SOURCE: HOW SMALL BUSINESSES BEGIN, National Federation of Independent Business, 1979.

Table 2

SOURCE OF SMALL BUSINESS CREDIT BY LOAN MATURITY (MONTHS)

	Maturity (Months)					
	1-12[a]			13-60		
Loan Source	1980	1982	1984	1980	1982	1984
Bank	90%	91%	89%	82%	78%	82%
Private Individual	4	4	3	5	8	4
Government	1	☆	1	2	1	1
Finance Company	1	1	1	4	5	5
Insurance Company	1	☆	1	1	1	1
Factors/Credit Cards[c]	☆	☆	☆	☆	☆	☆
Co-op/Credit Union[d]	1	1	1	1	1	3
Savings and Loan	1	1	1	1	2	1
Other	1	2	3	4	4	3
All Firms	100%	100%	100%	100%	100%	100%

	Maturity (Months)					
	Over 60			All Loans[b]		
Loan Source	1980	1982	1984	1980	1982	1984
Bank	70%	73%	71%	85%	84%	84%
Private Individual	9	10	4	5	6	5
Government	4	4	4	1	1	1
Finance company	2	2	2	2	2	2
Insurance company	1	2	1	1	1	1
Factors/Credit Cards[c]	☆	☆	☆	☆	☆	☆
Co-op/Credit Union[d]	1	1	2	1	1	1
Savings and Loan	7	4	8	2	2	2
Other	4	4	8	4	3	4
All Firms	100%	100%	100%	100%	100%	100%

[a] Includes revolving credit.

[b] Includes eighty-five (85) "no" answers in 1980. One hundred twenty-two (122) "no" answers in 1982, and ninety-three (93) "no" answers in 1984.

[c] In 1980, "Factors" and in 1982 "Credit Cards" were offered respectively as financing source choices.

[d] "Credit Union" category substituted for "Co-op" in 1984.

☆ Less than 0.5 percent.

institutions previously blocked from participation in this market.

There appears to be little new entry or competition from these new funding sources. The distribution of loan sources has remained virtually unchanged over the entire period covered by the surveys. S&Ls, for example, provided 2 percent of the most recent loans in 1984, just as they had in 1980. However, "deregulation" is still new, and lenders in general have many problems to solve before they can aggressively enter the new loan markets opened by deregulation. In addition, even if there were substantial penetration by new lenders, it would take time for the distribution of lending sources in the entire population of small firms to change appreciably.

B. Characteristics of Small Business Borrowers

At one time or another most small businesses borrow money. Over 90 percent of all firms have borrowed at some time in their history (Table 3). In 1984, 50 percent reported borrowing at least one time per year, down from 56 percent in 1980 and 52 percent in 1982.

Not all firms have the same capital needs, so borrowing activity will vary subtantially by such characteristics as firm size and industry (Table 3). For example, the proportion of regular borrowers in 1984 rises from a low of 33 percent for firms with annual sales under $50,000 to nearly 60 percent for firms with sales of $500,000 or more (Table 3A). The reduction in borrowing activity from 1980 is apparent among all sizes of firms.

Borrowing activity seemed to be highest among firms that have been in operation under current ownership from three to six years, followed by those in business from seven to 15 years (Table 3C). At either end of the age spectrum, activity was lower. Older firms (in business over 15 years) probably have reached their mature size, reducing the need for borrowing. For new firms, lower borrowing activity reflects the relative riskiness of new enterprises and the difficulty of raising funds. Borrowing activity was comparatively high for firms with the fastest sales growth (Table 3D). Those with declining sales borrowed more often than firms with steady sales reflecting the cash-flow problems created by sales declines.

Industry credit needs vary widely. Regular borrowing activity was highest in such areas as Agriculture (69 percent), Construction (59 percent) and Transportation (63 percent; includes utilities and communication) (Table 3E). Regular borrowing remained least frequent in the services industries, particularly in non-professional services where only 41 percent of the firms reported borrowing at least once per year.

Differences in borrowing activity across the various Census Regions were due in part to differences in industry concentration in these regions and the large differences in industry credit needs (Table 3G). For example, heavy agricultural concentration in rural areas and in the Midwest kept borrowing activity relatively higher in those groupings than in others. Heavy growth in the south and west likely kept construction borrowing heavier there than in the mid-section of the country.

Table 3

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3A

Borrowing Frequency by Gross Sales

Characteristics

Gross Sales ($000)	Percent of Firms 1980	1982	1984
Under 50	8	8	10
50-99	11	11	11
100-200	17	15	16
200-350	15	15	16
350-500	9	10	9
500-800	9	10	9
800-1500	12	12	11
1500-2999	7	8	8
3000 or more	9	10	9
All Firms*	100%	100%	100%

Borrowing Activity

Gross Sales ($000)	Frequent Borrowers* 1980	1982	1984	Infrequent Borrowers* 1980	1982	1984	Nonborrowers* 1980	1982	1984
Under 50	42	39	33	44	50	47	14	11	20
50-99	50	51	47	42	40	41	8	9	12
100-100	57	47	49	34	46	46	9	7	5
200-350	53	49	53	37	45	41	10	6	6
350-500	59	57	54	34	40	37	7	3	10
500-800	56	51	59	37	43	37	7	6	4
800-1500	65	61	55	28	36	44	6	3	2
1500-2999	64	62	57	31	35	38	5	3	5
3000 or more	68	63	50	30	33	41	2	4	3
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

Table 3 (Continued)

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3B

Borrowing Frequency by Employment Size

Characteristics

Full-time Employment	Percent of Firms 1980	1982	1984
One	10	7	12
Two	10	9	15
3-5	29	28	26
6-9	18	18	14
10-14	10	11	9
15-19	5	5	5
20-39	9	9	8
40 or more	9	8	5
All Firms [a]	100%	100%	100%

Borrowing Activity

Full-time Employment	Frequent Borrowers[b] 1980	1982	1984	Infrequent Borrowers[b] 1980	1982	1984	Nonborrowers[b] 1980	1982	1984
One	50	43	41	34	45	46	16	12	15
Two	53	46	50	38	48	42	9	6	8
3-5	53	49	48	38	43	45	9	8	8
6-9	55	54	53	38	42	41	7	4	6
10-14	61	57	52	31	38	41	8	5	6
15-19	64	59	55	29	38	41	7	3	4
20-39	67	61	60	30	38	38	3	1	2
40 or more	64	60	67	33	34	31	3	6	2
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

Firms were asked to estimate a ratio of total debt to total business assets. The results are reported in Table 4. Twenty two (22) percent reported that they had no debt at the time of the survey (early 1984); 56 percent reported debt as a percent of assets under 30 percent; and 11 percent reported that debt owed was

Table 3 (Continued)

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3C

Borrowing Frequency by Years in Business

Characteristics

Years in Business	Percent of Firms 1980	1982	1984
1-2	9	6	9
3-4	12	10	8
5-6	9	9	9
7-10	16	16	17
11-15	12	12	14
16-20	10	9	10
Over 20	32	37	32
All Firms [a]	100%	100%	100%

Borrowing Activity

Years in Business	Frequent Borrowers[b] 1980	1982	1984	Infrequent Borrowers[b] 1980	1982	1984	Nonborrowers[b] 1980	1982	1984
1-2	44	51	40	44	42	41	12	7	19
3-4	61	58	59	31	36	33	8	6	9
5-6	62	59	61	31	35	30	7	6	9
7-10	60	54	56	34	41	38	6	5	7
11-15	64	54	50	30	40	45	6	6	5
16-20	57	52	53	36	44	42	7	4	5
Over 20	52	50	44	38	44	50	10	6	6
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

equivalent to 60 percent or more of total assets. Smaller firms (measured in annual sales or employment) reported being debt-free more frequently and generally reported lower debt-to-asset ratios. The median debt-to-asset ratio for all firms was 13%, and 24% for those firms with debt.

A substantial decline in borrowing activity occurred between 1980 and 1982. The decline continued into 1984. The changes in borrowing activity seemed to follow the path of inflation (Table 5). High unanticipated inflation seriously eroded the cash flow of small firms. Unexpected price increases rendered available cash

Table 3 (Continued)

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3D

Borrowing Frequency by Sales Growth

Characteristics

Annual average sales growth (past 2-3 years)	Percent of Firms 1980	1982	1984
Over 20% (rapid)[c]	10	15	12
11-20% (growing)[c]	46	16	16
6-10%		22	21
0-5% (steady)[c]	26	20	23
Declined	11	19	20
Too new to measure	2	4	5
All Firms	100%	100%	100%

Borrowing Activity

Annual average sales growth (past 2-3 years)	Frequent Borrowers[b] 1980	1982	1984	Infrequent Borrowers[b] 1980	1982	1984	Nonborrowers[b] 1980	1982	1984
Over 20% (rapid)[c]	69	60	57	28	34	33	3	6	9
11-20% (growing)[c]	60	53	60	34	43	34	6	4	6
6-10%		51	46		42	49		7	6
0-5% (steady)[c]	52	49	47	41	47	46	7	4	7
Declined	58	57	51	34	38	43	8	5	6
Too new to measure	39	47	39	48	46	45	3	7	17
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

inadequate to finance new inventory purchases. Capital outlays required far more funds than produced by depreciation reserves. Also, due to unexpected cost increases, contracts for future activity produced losses instead of profits. Firms not put out of business by such events turned to banks and other lenders for working capital -- "survival borrowing." Thus, from 1978:IV the percent of firms borrowing regularly (at least once per quarter) rose from 38 percent to 51 percent a year later. Borrowing remained at these high levels until 1980.

The thirteen (13) percentage point increase meant that hundreds of thousands of firms became regular borrowers during the

Table 3 (Continued)

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3E

Borrowing Frequency by Industry

Characteristics

Industry:	Percent of Firms 1980	1982	1984
Construction	15	15	14
Manufacturing	12	12	11
Transportation	3	3	3
Wholesale	8	8	8
Retail	33	33	32
Agriculture	5	5	6
Financial	8	7	7
Service	10	11	12
Professional	6	6	7
All Firms[a]	100%	100%	100%

Borrowing Activity

Industry:	Frequent Borrowers[b] 1980	1982	1984	Infrequent Borrowers[b] 1980	1982	1984	Nonborrowers[b] 1980	1982	1984
Construction	68	63	59	24	31	33	8	6	8
Manufacturing	56	51	51	39	43	40	5	6	9
Transportation	70	63	63	23	37	35	7	0	2
Wholesale	61	54	49	33	43	44	6	3	7
Retail	52	49	45	38	45	47	9	6	8
Agriculture	73	74	69	21	21	30	6	5	2
Financial	56	48	47	31	44	41	13	8	12
Service	41	43	41	50	48	51	9	9	9
Professional	51	49	53	43	44	41	6	7	5
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

period. The number of regular borrowers increased by over 30 percent in spite of high interest rates. If there were four million firms (an estimate of the number of firms that actually employ workers), then the number of borrowers rose by over 500,000 in the twelve months beginning with the fourth quarter of 1977, and added billions of dollars to credit demand. With inflation at a much lower and more predictable level, borrowing activity fell to the low-40 percent range by early 1981 and has remained there through 1984.

Table 3 (Continued)

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3F

Borrowing Frequency by Location

Characteristics

Location:	Percent of Firms 1980	1982	1984
Rural	40	41	43
Small City	30	30	30
City	19	20	17
Metropolitan	8	8	8
All Firms[a]	100%	100%	100%

Borrowing Activity

Location:	Frequent Borrowers[b] 1980	1982	1984	Infrequent Borrowers[b] 1980	1982	1980	Non-borrowers[b] 1980	1982	1984
Rural	59	54	53	34	40	40	7	6	7
Small City	56	53	50	36	42	43	8	5	8
City	54	51	47	38	43	49	8	6	4
Metropolitan	60	49	51	35	46	36	5	5	13
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

II. SMALL BUSINESS LOAN CHARACTERISTICS

A. Size

In all three survey years, 49 percent of all small business loans were under $20,000. Loan sizes rose with maturity, as most of the large loans fell into longer maturities (Table 6). The average loan size declined to 1980 levels after rising between 1980 and 1982. The median loan size rose by about $1,000 to $20,500 in the last two years. However, there has been little change in the size of credit lines and longer-maturity loans.

As expected, loan size varied with firm sales and industry classification as well as with the purpose of the loan (Table 7). About 30 percent of the loans to wholesale, manufacturing, and agricultural firms were for $100,000 or more, about twice the

Table 3 (Continued)

FIRM CHARACTERISTICS AND BORROWING FREQUENCY

Table 3G

Borrowing Frequency by Geographic Region

Characteristics

Region[d]:	Percent of Firms 1980	1982	1984
New England	5	5	5
Mid-Atlantic	10	10	10
E. N. Central	16	18	17
W. N. Central	13	14	14
S. Atlantic	10	11	11
E. S. Central	4	4	4
W. S. Central	11	11	11
Mountain	9	9	10
Pacific	18	18	18
All Firms[a]	100%	100%	100%

Borrowing Activity

Region[d]:	Frequent Borrowers[b] 1980	1982	1984	Infrequent Borrowers[b] 1980	1982	1984	Nonborrowers[b] 1980	1982	1984
New England	44	47	47	50	48	47	6	5	7
Mid-Atlantic	52	47	49	42	44	43	6	9	8
E. N. Central	59	51	52	35	44	41	6	5	7
W. N. Central	62	64	53	31	33	44	7	3	3
S. Atlantic	51	47	50	38	46	42	11	7	8
E. S. Central	52	49	42	42	44	46	6	7	12
W. S. Central	63	58	60	31	37	33	6	5	7
Mountain	61	61	49	30	33	42	9	6	9
Pacific	54	46	45	34	46	46	12	8	10
All Firms	56%	52%	50%	35%	41%	42%	8%	6%	8%

[a] Does not add to 100% since firms not reporting a value for each characteristic are omitted.

[b] Frequent Borrowers = at least one time per year; Infrequent Borrowers = less than once per year; Nonborrowers = no borrowing reported at any time.

[c] In 1980, only verbal categories were used.

[d] Department of Commerce classifications.

Table 4

DEBT TO ASSET RATIO BY SELECTED VARIABLES
(1984 SURVEY)

Firm Location	None: No Answer	Under 10%	10-19%	20-29%	30-39%	40-49%	50-59%	60-69%	70% or More
Rural	20%	21%	14%	11%	9%	9%	6%	4%	6%
Small city	22	24	13	12	6	5	6	5	7
City	16	19	15	14	8	12	3	3	10
Metropolis	25	15	11	17	9	8	4	3	8
Gross Sales: ($000)									
Under $50	36	24	12	6	7	4	5	1	5
$50-99	21	23	12	11	8	11	5	3	6
$100-199	24	26	12	10	7	5	7	3	6
$200-349	24	22	15	9	7	8	5	5	5
$350-499	16	22	11	18	8	14	3	2	6
$500-799	16	20	19	14	7	12	4	4	4
$800-1,499	16	17	17	14	9	4	11	6	6
$1,500-2,999	15	20	9	17	11	4	4	7	13
$3,000 or more	19	12	10	17	6	12	3	8	13
Total Employment									
One	38	26	11	6	6	6	4	1	2
Two	29	19	13	7	5	10	6	3	8
3-5	23	22	11	14	8	7	6	3	6
6-9	20	22	15	8	8	8	7	5	7
10-14	19	14	17	17	10	11	2	2	8
15-19	20	22	15	15	3	6	6	5	8
20-39	16	21	14	12	10	5	6	10	6
40 or more	9	19	10	14	12	11	4	7	14
All Firms	22%	21%	13%	12%	8%	8%	5%	4%	7%

frequency as for the total population of small firms. Loans for expansion and property acquisition tended to be larger than loans for other purposes. However, the number of large loans for expansion declined from 1982 while property-acquisition loans increased.

Table 5

BORROWING ACTIVITY FOR ALL FIRMS

Year/Quarter		Percent Borrowing*	Inflation Rate*
1974	I	41	10.4
	II	45	11.6
	III	42	12.6
	IV	38	8.3
1975	I	42	4.8
	II	39	8.0
	III	39	7.4
	IV	39	4.6
1976	I	39	3.3
	II	39	6.4
	III	40	5.6
	IV	40	7.6
1977	I	40	7.0
	II	41	5.5
	III	40	5.9
	IV	38	6.9
1978	I	47	9.1
	II	47	9.3
	III	46	9.3
	IV	51	9.9
1979	I	na	13.1
	II	46	12.7
	III	48	12.7
	IV	46	15.8
1980	I	50	13.5
	II	41	7.1
	III	43	11.4
	IV	45	10.9
1981	I	44	8.5
	II	45	11.0
	III	43	6.5
	IV	40	3.7
1982	I	40	5.4
	II	41	7.1
	III	42	1.5
	IV	40	0.3
1983	I	44	4.4
	II	42	4.0
	III	40	4.4
	IV	39	4.9
1984	I	39	3.7
	II	44	3.5
	III	40	3.8

Notes to Table 5

*	Percent of all firms borrowing at least once in every quarter. Surveys are taken in the first month following each quarterly period.
•	Based on the Consumer Price Index.
na	Not asked

SOURCE: Quarterly Economic Report for Small Business, National Federation of Independent Business.

B. Maturity

The maturity distribution of loans changed little from the 1980 and 1982 surveys (Table 8). Forty-six (46) percent were for 12 months or less, 31 percent for 13 to 60 months and 12 percent were for 61 months or longer. The median maturity of loans in each category changed little from earlier surveys (Table 9). Average maturities rose for short- and medium-term loans, reflecting a shift in the distribution toward the long-end. But the average maturity of long-term loans fell from 155 to 147 months.

Loan maturity closely matched the use to which the funds were applied (Table 10). Relatively few short-term loans were used to finance the acquisition of property or plant and equipment (expansion). The "expansion" category was expanded by the inclusion of two new loan-use categories in the 1984 survey: "Start a New Business" and "Move Business Location." Combining these two categories with the percentage under "expansion" shows that this use of funds did not change by maturity structure. Some firms remained "mismatched" in maturity and loan use. Firms financing the acquisition of property or a relocation or expansion with short-term borrowing (3%, 9%, and 2% respectively) under normal circumstances will have to refinance those amounts in the very near future. The use of long-term money for "short-term" uses such as inventory finance or the payment of tax or payroll obligations (7% and 22%, respectively) may indicate a longer-term commitment to raise the debt/asset ratio of the firm or the opportune acquisition of borrowed funds at favorable rates.

Table 6

LOAN SIZE BY LOAN MATURITY

Loan Size: ($000)	All Loans 1980	1982	1984	Short-Term 1980	1982	1984
Under 5	14%	13%	12%	67%	59%	60%
5-9	16	15	16	57	47	55
10-19	18	21	21	57	49	49
20-39	20	17	18	51	49	52
40-69	12	11	11	43	48	50
70-99	4	4	3	41	37	20
100-149	5	6	7	41	28	50
150-199	2	3	3	35	45	33
200-299	3	3	3	34	32	29
300-399	1	1	1	47	46	27
400-599	2	3	2	29	37	48
600-999	1	1	1	32	24	60
1000-2000	1	1	1	31	33	38
Over 2000	*	1	*	50	10	50
All Firms	100%	100%	100%	52%	47%	50%

Table 6 (Continued)

LOAN SIZE BY LOAN MATURITY

Loan Size: ($000)	Medium-term 1980	1982	1984	Long-term 1980	1982	1984	Revolving Credit 1980	1982	1984
Under 5	26%	32%	33%	1%	1%	8%	1%	2%	4%
5-9	31	44	40	4	3	6	2	1	3
10-19	28	37	40	7	6	11	4	2	2
20-39	28	28	34	15	13	13	3	3	3
40-69	31	24	28	19	17	22	3	3	4
70-99	29	34	30	27	23	50	2	1	6
100-149	24	26	21	20	35	29	11	1	5
150-199	17	16	21	33	22	45	9	9	11
200-299	23	20	24	28	33	39	11	6	5
300-399	13	14	20	28	25	53	9	7	11
400-599	27	15	14	22	33	38	22	4	12
600-999	12	16	20	24	44	20	24	12	6
1000-2000	19	8	13	25	42	50	13	*	11
Over 2000	10	20	*	30	40	50	10	10	*
All Firms	27%	31%	33%	12%	13%	17%	4%	2%	4%

Maturity	Mean Loan Size 1980	1982	1984	Median Loan Size 1980	1982	1984
1-12 months	$54,950	$54,130	$71,460	$14,580	$14,960	$18,200
13-60 months	55,150	49,840	42,090	19,250	13,550	16,890
61+ months	145,620	195,950	135,520	50,070	78,500	76,920
Revolving Credit	201,360	176,860	127,240	50,500	40,160	40,000
All Loans	$72,800	$78,630	$72,390	$19,780	$19,610	$20,540

Table 7

FIRM AND LOAN CHARACTERISTICS BY LOAN SIZE

	Distribution of All Firms			Loan Size: Under $5000			Loan Size: $5000-9999		
Characteristics	1980	1982	1984	1980	1982	1984	1980	1982	1984
Gross Sales: ($000)									
Under 50	7%	7%	8%	46%	42%	42%	19%	24%	19%
50-99	12	11	11	28	20	29	27	19	32
100-199	17	16	16	19	21	15	28	25	26
200-349	16	15	16	13	11	11	18	19	19
350-499	9	10	9	10	10	7	16	14	15
500-799	9	10	10	4	5	5	10	14	7
800-1499	12	12	11	2	2	3	6	8	4
1500-2999	8	8	8	2	2	2	4	5	4
3000- or more	9	9	9	2	1	5	4	*	1
No answer	1	2	2	14	17	20	30	17	16
Industry:									
Construction	16	15	14	10	8	9	15	14	15
Manufacturing	12	12	11	10	9	12	11	9	7
Transportation	3	3	3	6	*	10	9	10	12
Wholesale	8	7	8	4	6	3	9	7	5
Retail	33	34	31	18	16	15	19	17	20
Agriculture	5	5	7	8	4	12	10	10	12
Financial	7	7	6	11	13	15	22	19	15
Service	10	11	11	25	30	27	20	18	22
Professional	6	6	7	17	15	7	22	22	18
No answer	*	*	2	*	14	9	20	*	22
Loan purpose:									
Inventory	25	20	24	13	12	12	13	16	15
Tax, payroll, debt	27	24	34	13	18	16	16	13	15
Maintenance	14	18	19	17	15	17	29	19	23
Property	8	7	6	7	7	1	11	9	5
Expansion	22	25	17	10	6	13	12	13	14
No answer	4	7	3	-	-	-	-	-	-
All Firms	100%	100%	100%	13%	12%	13%	16%	14%	16%

Table 7 (Continued)

	Loan Size: $10,000-19,999			$20,000-39,999			$40,000-99,999		
Characteristics	1980	1982	1984	1980	1982	1984	1980	1982	1984
Gross Sales: ($000)									
Under 50	13%	19%	20%	14%	9%	8%	4%	4%	8%
50-99	21	24	20	14	15	10	6	9	5
100-199	24	26	23	12	13	19	11	8	9
200-349	23	26	27	24	18	20	14	16	11
350-499	27	30	30	25	18	20	14	17	17
500-799	21	26	26	32	25	25	20	16	14
800-1499	16	19	17	28	27	24	28	26	26
1500-2999	7	12	10	24	21	20	31	25	36
3000 or more	2	3	4	14	9	12	16	19	18
No answer	18	21	24	25	15	24	9	24	8
Industry:									
Construction	19	22	21	18	21	20	18	16	15
Manufacturing	17	22	16	19	15	18	19	19	16
Transportation	25	25	20	21	18	20	22	16	20
Wholesale	11	16	13	24	20	26	25	22	20
Retail	17	22	24	20	16	17	15	15	14
Agriculture	18	12	15	23	19	19	18	21	16
Finance	25	17	24	22	21	14	8	16	18
Services	20	21	21	19	13	14	8	11	8
Professional	23	27	26	25	18	22	9	10	16
No answer	*	14	17	40	29	9	20	14	22
Loan purpose:									
Inventory	17	22	19	20	20	20	18	17	15
Tax, payroll, debt	21	24	20	21	22	19	13	11	15
Maintenance	18	24	27	16	14	13	8	12	10
Property	14	16	12	23	18	21	19	20	26
Expansion	15	18	21	22	14	20	20	18	13
No answer	-	-	-	-	-	-	-	-	-
All Firms	18%	21%	21%	20%	18%	18%	16%	15%	15%

Table 7 (Continued)

Characteristics	Loan Size $100,000-299,999 1980	 1982	 1984	 $300,000 or more 1980	 1982	 1984
Gross Sales: ($000)						
Under 50	2%	1%	2%	2%	1%	1%
50-99	4	3	2	*	*	2
100-199	5	6	6	1	2	2
200-349	6	8	10	1	2	2
350-499	5	8	10	3	3	1
500-799	9	12	16	4	2	7
800-1499	17	13	20	3	5	6
1500-2999	24	26	19	8	9	9
3000 or more	30	32	32	32	36	28
No answer	4	2	4	*	4	4
Industry:						
Construction	14	13	14	6	6	6
Manufacturing	10	17	23	12	9	8
Transportation	12	11	10	7	20	8
Wholesale	19	16	19	9	12	10
Retail	8	10	9	3	4	1
Agriculture	14	23	16	10	12	14
Finance	9	9	8	4	6	6
Services	5	4	6	3	2	2
Professional	2	4	8	2	2	3
No answer	20	*	13	*	29	8
Loan purpose:						
Inventory	10	8	14	6	5	5
Tax, payroll, debt	8	9	11	5	2	4
Maintenance	7	9	7	2	7	3
Property	13	21	27	9	9	8
Expansion	14	18	12	6	11	7
No answer	-	-	-	-	-	-
All Firms	10%	12%	12%	5%	6%	5%

* Less than 0.5 percent.

Table 8

YEAR LAST LOAN OBTAINED BY LOAN MATURITY

April 1980 Survey	Months 1-12	 13-60	 61 or More	Revolving Credit	All Firms*
Date of loan					
1980 I	42%	21%	14%	54%	33%
1979 IV	16	13	8	8	14
1979 III	8	10	7	10	8
1979 II	8	9	8	8	8
Prior to 1979 II	21	44	56	19	32
Not ascertained	5	3	7	1	5
Number of loans	1170	602	269	96	2218
Percent of total	53%	27%	12%	4%	100%
April 1982 Survey					
Date of loan					
1982 I	45%	29%	15%	23%	33%
1981 IV	17	18	21	15	18
1981 III	10	12	11	8	10
1981 II	9	11	14	13	11
Prior to 1981 II	16	28	36	33	23
Not ascertained	3	2	3	8	3
Number of loans	916	605	253	52	1948
Percent of total	47%	31%	13%	3%	100%
April 1984 Survey					
Date of loan					
1984 I	46%	27%	19%	53%	31%
1983 IV	18	15	13	6	13
1983 III	9	15	11	9	10
1983 II	8	13	17	7	9
Prior to 1983 II	16	28	36	18	28
Not ascertained	3	2	4	7	9
Number of Loans	643	426	170	55	1387
Percent of Total	46%	31%	12%	4%	100%

* Includes 85 "no answers" in 1980, 122 "no answers" in 1982, and 93 "no answers" in 1984.

Table 9

LOAN MATURITY

Maturity (months)	Short-Term 1980	Short-Term 1982	Short-Term 1984	Medium-Term 1980	Medium-Term 1982	Medium-Term 1984	Long-Term 1980	Long-Term 1982	Long-Term 1984
	Loan Description								
1-3	45%	42%	36%						
4-6	28	31	31						
7-12	27	27	33						
13-18				5%	4%	4%			
19-24				21	20	17			
25-36				32	37	32			
37-48				11	12	15			
49-60				31	27	32			
61-96							32%	28%	26%
97-120							35	31	37
121-180							20	20	21
181 or more							13	21	16
Mean maturity	5.9	6.1	6.6	41.2	40.6	42.0	140.6	155.4	146.9
Median maturity	5.5	5.7	5.6	36.2	36.2	35.4	120.0	120.2	120.2

Table 10

LOAN MATURITY BY LOAN PURPOSE

				Purpose					
	All Purposes			Inventory			Tax, Payroll, Debt		
Maturity	1980	1982	1984	1980	1982	1984	1980	1982	1984
Short-Term (1-12 mos)	57%	50%	41%	35%	29%	30%	36%	35%	38%
Medium-Term (13-60 mos)	27	31	25	10	10	9	17	13	16
Long-Term (over 60 mos)	12	13	10	6	6	7	13	7	22
All Firms	100%	100%	100%	25%	20%	18%	27%	24%	25%

Table 10 (Continued)

LOAN MATURITY BY LOAN PURPOSE

	Purpose								
	Maintenance			Property			Expansion		
Maturity	1980	1982	1984	1980	1982	1984	1980	1982	1984
Short-Term (1-12 mos)	9%	12%	12%	4%	5%	3%	11%	13%	9%
Medium-Term (13-60 mos)	27	31	29	8	6	5	34	35	23
Long-Term (over 60 mos)	10	15	7	23	15	18	45	47	25
All Firms	14%	18%	14%	8%	7%	5%	22%	25%	14%

	Purpose					
	Start New Business[a]			Move Location[a]		
Maturity	1980	1982	1984	1980	1982	1984
Short-Term (1-12 mos)			5%			2%
Medium-Term (13-60 mos)	na	na	10	na	na	3
Long-Term (over 60 mos)			15			5
All Firms			8%			3%

[a] These categories are new in the 1984 survey; for consistency with past surveys, they are included in the category "expansion" in prior tables.

na Not asked

C. Collateral Requirements

Some form of collateral was used for 62 percent of the loans reported in the 1984 survey, virtually identical to the 1980 and 1982 figures (Table 11). Long-term loans were more likely to be collateralized. Eighty-six (86) percent of those loans carried some type of security. Far fewer (56 percent) short-term loans were collateralized. The incidence of collateral rose with loan size, reflecting the increase in the borrower's leverage on the lender and the corresponding increase in risk. The relative cost (as a percent

Table 11

COLLATERAL BY SELECTED VARIABLES

	Distribution of All Firms			Percent with Collateral		
	1980	1982	1984	1980	1982	1984
Loan Maturity:						
1-12 months	56%	51%	50%	49%	52%	56%
13-60 months	27	29	33	73	67	67
61 months or more	10	11	13	89	87	86
Revolving credit	4	3	4	67	55	65
Loan Size: ($000)						
Under 5	13	12	13	36	37	47
5-9	15	15	16	52	47	47
10-19	19	21	21	56	61	62
20-39	21	18	19	65	65	62
40-99	16	15	15	71	70	72
100-299	10	12	12	76	76	82
300 or more	5	6	4	83	82	86
Years in Business:						
1-2	8	6	8	71	71	71
3-4	12	10	8	68	76	67
5-6	9	9	9	64	66	64
7-10	17	17	17	67	64	63
11-15	13	12	14	61	67	62
16-20	10	9	11	60	54	56
Over 20	30	36	33	49	52	50
All Firms	100%	100%	100%	62%	64%	62%

Table 12

TYPE OF COLLATERAL BY SELECTED VARIABLES

	Distribution of Borrowing Firms			Collateral Requirements					
				None			Business		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Short-Term	57%	50%	43%	47%	43%	41%	23%	25%	22%
Medium-Term	27	31	27	28	35	31	36	32	33
Long-Term	12	13	10	13	15	11	37	39	34
No answer	4	6	20	44	30	60	25	25	13

Table 12 (Continued)

TYPE OF COLLATERAL BY SELECTED VARIABLES

	Distribution of Borrowing Firms			Collateral Requirements					
				None			Business		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Industry:									
Construction	16	15	13	38	36	46	29	29	19
Manufacturing	12	13	10	32	34	34	28	32	28
Transporation	3	3	3	42	38	22	37	31	35
Wholesale	9	8	8	33	30	31	26	29	29
Retail	32	33	32	38	37	42	26	29	21
Agriculture	5	5	7	28	31	31	49	41	42
Finance	8	7	6	48	41	43	22	17	21
Services	9	10	12	37	37	42	28	26	25
Professional	6	6	7	44	41	41	31	32	24
No answer	*	*	1	20	*	46	20	1	15
Loan Source:									
Bank	85	84	79	37	35	37	28	30	26
Individual	5	6	4	59	56	60	22	14	12
Government	1	1	1	4	22	12	52	39	35
Finance company	2	2	2	33	29	40	26	32	15
Insurance	1	1	1	55	53	61	25	27	23
Factor/credit cards	*	*	*	25	*	*	50	*	*
Co-op/credit union	1	1	1	12	24	38	56	53	14
S&L	2	2	2	21	22	17	27	19	44
Other	2	2	4	32	29	35	43	43	38
No answer	1	1	6	57	50	79	24	43	6
All Borrowing Firms	100%	100%	100%	38%	36%	38%	28%	29%	24%

	Collateral Requirements								
	Personal			Business And Personal			Compensating Balances		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Short-Term	9%	2%	2%	13%	18%	29%	3%	5%	2%
Medium-Term	10	5	5	18	20	25	1	2	1
Long-Term	11	8	9	29	28	3	2	38	3
No answer	11	3	4	14	26	18	*	4	2

Table 12 (Continued)

	Collateral Requirements								
	Personal			Business And Personal			Compensating Balances		
Loan maturity:	1980	1982	1984	1980	1982	1984	1980	1982	1984
Industry:									
Construction	8	5	5	17	20	26	2	4	2
Manufacturing	9	1	3	20	20	29	3	4	2
Transporation	3	2	*	15	15	39	*	5	*
Wholesale	8	3	2	22	23	32	2	5	2
Retail	11	4	5	18	21	27	2	3	2
Agriculture	1	2	1	14	17	21	2	1	2
Finance	12	7	7	7	21	22	3	8	2
Services	13	5	3	15	22	25	2	4	2
Professional	11	3	*	10	16	25	2	2	4
No answer	*	*	4	40	*	23	20	*	4
Loan Source:									
Bank	10	4	3	17	21	28	2	4	2
Individual	5	3	*	11	15	28	2	3	*
Government	*	11	6	40	17	41	*	6	*
Finance company	14	10	6	26	27	27	2	*	*
Insurance	5	*	8	30	7	8	*	7	*
Factor/credit cards	*	*	*	*	*	*	*	*	*
Co-op/credit union	8	*	10	16	18	24	4	*	*
S&L	32	16	13	6	41	23	3	*	*
Other	4	*	3	15	16	22	*	4	2
No answer	5	*	2	*	*	12	5	*	*
All Borrowing Firms	9%	4%	4%	17%	20%	27%	2%	4%	2%

	Collateral Requirements		
	Other Combinations		
	1980	1982	1984
Loan maturity:			
Short-Term	5%	6%	4%
Medium-Term	6	7	5
Long-Term	8	7	5
No answer	6	11	3

Table 12 (Continued)

	Collateral Requirements		
	Other Combinations		
	1980	1982	1984
Industry:			
Construction	5	7	2
Manufacturing	8	9	4
Transporation	3	9	4
Wholesale	7	9	4
Retail	5	6	4
Agriculture	6	8	3
Finance	8	6	5
Services	5	6	3
Professional	2	5	6
No answer	*	17	8
Loan Source:			
Bank	6	7	4
Individual	1	9	*
Government	4	6	6
Finance company	*	2	12
Insurance	5	7	*
Factor/credit cards	*	*	*
Co-op/credit union	*	6	4
S&L	12	3	3
Other	7	8	*
No answer	5	7	1
All Borrowing Firms	6%	7%	3%

*Less than 0.5 percent

of the total loan amount) of creating and monitoring a secured interest declines with increasing loan size. Firms securing large loans also more frequently were engaged in activities with readily identifiable assets which can be used in security arrangements (agriculture, transportation, etc.).

Newer firms, more likely to fail and default on their obligations, reported the highest incidence of collateralized loans. Seventy-one (71) percent of the loans to firms in business less than three years were collateralized. This percentage declined to 50 percent for firms in business 20 years or more.

Business assets were used more often as collateral (24 percent) than were personal assets (4 percent). However, business assets in combination with personal assets was the most frequent

Table 13

FORM OF COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Business Collateral				
	Accounts Receivable	Inventory	Plant & Equipment	Business Real Estate	Don't Know
Industry:					
Construction	42%	14%	26%	18%	*%
Manufacturing	25	13	45	13	4
Transportation	23	6	61	10	*
Wholesale	25	25	24	24	2
Retail	10	37	26	23	4
Agriculture	12	29	36	21	2
Finance	11	13	22	51	3
Services	13	27	29	26	5
Professional	30	4	45	19	2
No answer	34	11	44	11	*
Loan source:					
Bank	21	25	32	20	2
Individual	19	19	6	50	6
Government	8	8	59	25	*
Finance company	*	20	40	40	*
Insurance co.	*	66	*	34	*
Factor/credit cards	*	*	*	*	*
Co-op/credit union	33	*	67	*	*
S&L	6	17	17	50	10
Other	8	26	37	23	6
No answer	1	6	57	50	79
Loan maturity:					
Short-term	34	31	19	15	1
Medium-term	8	20	55	16	1
Long-term	5	13	30	48	4
All Collateralized Loans	20%	23%	32%	22%	3%

collateral form (27 percent; Tables 12 and 13). The type of collateral used was related to characteristics of the firm. Accounts receivable were most often used to secure loans in construction (42 percent of collateralized loans) and the professional services (30 percent). Retailers (37 percent), wholesalers (25 percent) and

Table 13 (Continued)

FORM OF COLLATERAL REQUIREMENTS BY SELECTED VARIABLES

	Personal Collateral				
	House	Stock	Personal Guarantee	Other	Don't Know
Industry:					
Construction	31%	6%	57%	6%	*%
Manufacturing	19	7	69	3	2
Transportation	10	11	63	16	*
Wholesale	10	4	82	2	2
Retail	30	7	50	11	2
Agriculture	8	12	48	28	4
Finance	28	14	48	4	6
Services	26	10	44	10	10
Professional	12	9	69	6	4
No answer	22	*	66	*	12
Loan source:					
Bank	23	7	59	8	3
Individual	4	14	62	10	10
Government	33	*	67	*	*
Finance company	38	8	46	8	*
Insurance co.	50	*	50	*	*
Factor/credit cards	*	*	*	*	*
Co-op/credit union	20	10	10	60	*
S&L	36	*	55	9	*
Other	28	17	44	*	11
Loan maturity:					
Short-term	16	9	67	7	1
Medium-term	29	7	55	7	2
Long-term	40	6	40	12	2
All Collateralized Loans	24%	8%	57%	8%	3%

*Less than 0.5 percent.

agricultural firms (29 percent) most frequently used inventory for security. Firms in manufacturing (45 percent of secured manufacturing loans) and transportation (61 percent) most frequently used fixed assets to collateralize a loan.

Banks, which account for most of the loans made, used the most diversified types of collateral. A very large percentage of the personally collateralized loans were secured by a "personal guarantee." The few very new firms able to get a loan often have a few business assets to offer as collateral. These loans are more frequently secured by the personal assets of the firm's owner(s). For the most part, these agreements give the lender access to all the personal assets of the individual in the case of default. However, such agreements raise the monitoring costs for the lender. Longer term loans tended to be secured with fixed assets and real estate. Most likely, the loans were actually used to finance the acquisition of the assets used for collateral.

D. Lines of Credit and Compensating Balances

For frequent borrowers, open lines of credit and similar borrowing arrangements are lower-cost ways to borrow needed funds. They eliminate the cost of repeated loan applications and provide a more secure pool of funds. The firm is usually charged for such arrangements, explicitly in the form of regular fees, or implicitly through the maintenance of compensating balances (a required percentage of the credit line that must be maintained in a demand deposit account).

Pre-approved lines of credit were reported by 38 percent of all firms, up from 32 percent in 1982 (Table 14). Construction, manufacturing, wholesale and agricultural firms most frequently used lines of credit. Use of such lines was least frequent in the services industry. The frequency of credit lines rose with firm sales. Thirty (30) percent of the smallest reported credit lines compared to 55 percent among firms with sales of $3 million or more. Frequent borrowers were most likely to use a credit line, and the lines were most likely to be extended in conjunction with large loan amounts.

Compensating balances were reported by only 6 percent of the borrowing firms, down from 10 percent in 1982 (Table 15). They were most frequently reported by firms that were very small (annual sales under $100,000) or very large (annual sales of $3 million or more). The frequency of compensating balances was the same for all loan sizes except the very largest category (loans of $300,000 or more). Large loans often represent large lines of credit (see Table 14) and not surprisingly more often involved a compensating balance. Sixteen (16) percent of these required balances compared to 6 percent for all loans. The use of compensating balances showed little variation by bank size or market area (Table 16). Loans at the largest banks and loans in metropolitan markets were somewhat more likely to require compensating balances, but loans in these markets tended also to be larger (see Table 15).

Table 14

PRE-APPROVED LINES OF CREDIT BY SELECTED VARIABLES

	1980	1982	1984
Industry:			
Construction	na	44%	51%
Manufacturing		31	42
Transportation		31	35
Wholesale		41	43
Retail		29	34
Agriculture		47	59
Finance		27	29
Services		19	29
Professional		18	27
Gross Sales: ($000)			
Under 50	na	18	30
50-99		24	30
100-199		26	36
200-349		26	34
350-499		33	33
500-799		32	33
800-1,499		39	47
1,500-2,999		49	48
3,000 or more		43	55
Loan Size:			
Under $5000	na	23	29
$5000-9999		26	39
$10,000-19,999		25	40
$20,000-39,999		33	37
$40,000-99,999		40	46
$100,000-299,999		42	55
$300,000 or more		46	46
Borrowing Frequency: (times per year)			
None	na	22	30
1		29	40
2		35	36
3 or more		52	60
Loan maturity (months):			
1-12	na	40	49
13-60		22	30
61 or more		18	29
All Firms	na	32%	38%

na Not asked

Table 15

COMPENSATING BALANCES BY SELECTED VARIABLES

	Distribution of All Firms			Balance Requirements		
	1980	1982	1984	1980	1982	1984
Gross Sales: ($000)						
Under 50	na	7%	10%	na	10%	7%
50-99		11	11		12	9
100-199		15	16		10	4
200-349		15	16		9	5
350-499		10	9		8	3
500-799		9	9		10	5
800-1,499		9	11		10	5
1,500-2,999		12	8		11	6
3,000 or more		10	9		12	10
Loan Size:						
Under $5000	na	12	11	na	10	7
$5000-9999		14	13		9	4
$10,000-19,999		21	17		9	7
$20,000-39,999		18	15		9	7
$40,000-99,999		15	12		6	7
$100,000-299,999		12	10		12	7
$300,000 or more		6	4		17	16
All Firms	na	100%	100%	na	10%	6%

na Not asked

Table 16

LINES OF CREDIT AND COMPENSATING BALANCES BY SELECTED VARIABLES

	Percent With Lines of Credit			Percent With Compensating Balances		
	1980	1982	1984	1980	1982	1984
Bank Asset Size. ($Millions)						
Under 100	na	29%	33%	na	9%	5%
100-500		35	23		10	7
Over 500		33	35		10	7
Don't Know		19	5		16	4

Table 16 (Continued)

LINES OF CREDIT AND COMPENSATING BALANCES BY SELECTED VARIABLES

	Percent With Lines of Credit			Percent With Compensating Balances		
	1980	1982	1984	1980	1982	1984
Market Size:						
Rural	na	31	37	na	9	6
Small City		32	35		10	7
City		31	40		10	6
Metropolitan		37	31		14	6
All Firms	na	32%	36%	na	10%	6%

na Not asked

E. Interest Rates

The average interest rate paid by small business borrowers is shown in Table 17 by maturity and date of origination. For all maturities, interest rates have risen substantially since the early 1970s. However, rates have moderated in the last few years after reaching record high levels. The term structure of rates remained quite flat through mid-1984. The early 1980s were characterized by substantially higher short-term than long-term rates. In April, 1982, the prime rate was at 16.5 percent. A year later, it had fallen to 10.5 percent, and than rose to 13 percent two years later. Throughout this volatile period, the average rate paid by small businesses on short-term loans ranged between 13.2 percent and 14.0 percent, while long-term rates ranged from 12.5 percent to 14.0 percent.

The proportion of loans tied to the prime rate rose from 32 percent in the second quarter of 1982 to 46 percent in the third quarter of 1984. In fact, the proportion of loans with interest tied to variable rates is one of the most dramatic changes small businesses have encountered in the financial markets over the past few years (Table 18).

The notion that small businesses routinely pay well above the prime rate is clearly incorrect, particularly when the prime rate has been rising. As many as 60 percent of small firms reported short-term loans below prevailing prime. When the prime rate is falling, the spread between small business rates and the prime tends to widen. This pattern has been moderated, however, by the increasing proportion of loans with contract rates tied to the prime rate.

Table 17

AVERAGE INTEREST RATES[a] PAID BY MATURITY

Date of Loan	Number of Loans	Maturity (Months) 1-12[b]	13-60	Over 60
April 1980 Survey:				
1974 or earlier	114	7.6%	8.5%	7.2%
1975	30	8.9	8.6	8.3
1976	53	8.8	9.2	11.3
1977	85	9.6	10.9	10.1
1978	194	10.4	11.3	10.3
1979 I	103	12.2	12.7	11.5
1979 II	159	12.7	13.0	12.6
1979 III	169	12.5	12.8	12.2
1979 IV	274	14.4	14.0	13.2
1980 I	620	16.4	15.2	14.0
April 1982 Survey:				
1981 I	137	16.0	15.7	14.9
1981 II	156	16.1	15.9	14.2
1981 III	173	17.4	16.2	14.1
1981 IV	297	17.5	16.5	14.2
1982 I	592	17.7	17.3	16.9
April 1984 Survey:				
1983 I	87	13.6	13.4	14.0
1983 II	128	13.5	14.0	12.5
1983 III	135	14.0	13.6	12.8
1983 IV	191	13.2	13.2	13.4
1984 I	443	13.3	13.7	13.0

[a] If the loan rate were tied to the prime rate, the prime rate applicable at the date of origination was used.

[b] included revolving credit.

The increasing proportion of loans tied to a market interest rate such as the prime rate make comparisons of rates paid more difficult, especially for longer maturities. The interest rate figures presented here represent the interest rate paid by the firm at the time the loan was taken. All variable rate loans were converted to a fixed rate by using the average U.S. prime rate that prevailed during the quarter in which the loan originated. Unfortunately, short-term interest rates at times have moved several hundred basis points in a matter of weeks. During period of such interest rate volatility, the conversion of the variable rate to a fixed rate using the average prime rate for the quarter could introduce some error, although it is not likely to be systematic.

Rates paid on small loans tended to be larger than those paid on large loans, reversing the findings of the two earlier studies (Table 19). This result is consistent with the emergence of a more traditional yield curve once inflation stabilized at a low level. Collateralized loans continued to carry higher rates in 1984 except among long-term loans. Proprietorships replaced partnerships as the form of business with the highest average rate on loans of all maturities. Corporate borrowers paid consistently lower rates, a pattern not characterizing earlier findings. This clearer differential may reflect in part the increased risk of lending to non-incorporated borrowers resulting from liberalization of the personal bankruptcy law. The new law, which took effect on October 1, 1980, shielded more assets from the lender in the case of a default. The new law automatically stayed efforts to recover assets once a bankruptcy filing was made, and made it easier for proprietorships with less than $100,000 in unsecured debt to proceed in Chapter 13 bankruptcy.

Reversing their earlier position, small banks charged more for short-term loans than did medium and large banks. Only their rates on medium-term loans were the lowest of the three size categories. Banks in large metropolitan areas provided the cheapest loans. In 1980 and 1982, these lenders were the most expensive. It would appear that deregulation and the competition for deposits has finally impacted rural banks. However, with rates generally declining over the period and urban areas more inclined to provide variable rates, a parity of rates for similar type loans now appears to be the norm.

In the 1984 survey, firms were asked to estimate their overall debt-to-asset ratio. The results are presented in Table 20 in two ways. In the top half of the table, the distribution of debt-to-asset ratios in each interest rate category is shown. One might use these data to answer questions like "Do most firms paying low rates have low debt-to-asset ratios?". The bottom half of the table shows the distribution of rates paid within each debt-to-asset category. This can be used to answer questions like "Do firms with high debt-to-asset ratios more frequently pay higher interest rates?".

Firms with very large debt-to-asset ratios tended to pay higher rates for their loans (lower panel, Table 20). However, the relationship between the debt-to-asset ratio and the interest rate paid is not particularly strong. About 23 percent of the firms with the highest ratios (over 70%) paid rates above 15 percent, but the proportion of firms in this highest rate category does not decline dramatically or sysematically with declining debt-to-asset ratios. Loan rates are clearly correlated with the debt/asset ratio, but other important factors obviously impact the determination of the rate charged as well.

Table 18

INTEREST RATES PAID ON SHORT-TERM LOANS•

Rate Paid	1982 2Q	1982 3Q	1982 4Q	1983 1Q	1983 2Q	1983 3Q	1983 4Q	1984 1Q	1984 2Q	1984 3Q
Under 13%	1%	1%	8%	14%	18%	16%	15%	16%	8%	4%
13%-15%	4	19	32	36	37	34	37	39	42	40
16%-18%	52	37	20	11	8	6	7	5	4	8
19% or more	11	5	2	2	2	2	1	*	3	1
Prime▪, +1	18	23	23	20	19	17	22	21	22	25
Prime▪, +2	12	12	13	14	13	20	14	15	18	17
Prime▪, +3 or more	2	3	2	3	3	5	4	4	3	4
TOTAL	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Average Rate Paid	17.6	15.4	14.1	13.5	13.2	13.2	13.3	13.2	14.0	14.4
Average Prime Rate	16.5	14.7	12.0	10.9	10.5	10.8	11.0	11.0	13.0	13.0

• Borrowing firms that did not report the interest rate are excluded. Data for the third quarter of 1984 were collected in the October survey.

▪ Beginning in 1982, the category "prime + " was added to the interest rate question. In prior quarters, the information was volunteered or the conversion was made by the respondent.

* Less than 0.5 percent

SOURCE: Quarterly Economic Report for Small Business, National Federation of Independent Business.

III. CREDIT AVAILABILITY

A. Ability to Obtain Credit

Most small businesses have been able to arrange the credit they needed (Table 21). Fifty-three (53) percent reported that all their credit needs had been met, up from 51 percent in 1982 but below the 56 percent reported in 1980. The percent of firms reporting that "All" or "Most" of their credit needs were met has declined, however, from 82% in 1980 to 73% in 1982 to 71% in 1984.

Table 19

AVERAGE INTEREST RATES PAID BY LOAN TERM AND FIRM CHARACTERISTICS

Characteristics	Short-Term 1980	Short-Term 1982	Short-Term 1984	Medium-Term 1980	Medium-Term 1982	Medium-Term 1984	Long-Term 1980	Long-Term 1982	Long-Term 1984
Loan Size: ($000)									
under $5	14.4%	17.2%	13.7%	14.3%	17.1%	14.1%	--	--	--
$5-9	14.1	16.6	13.4	13.9	16.6	13.9	12.7	16.7	13.5
$10-19	14.4	17.3	13.3	13.8	16.2	13.4	11.7	18.1	14.7
$20-39,000	15.0	17.7	13.2	12.9	16.3	13.4	13.1	14.9	13.6
$40-99,	15.6	18.0	12.9	14.3	17.0	13.3	12.3	13.4	13.1
$100-299	16.4	17.0	13.2	14.6	16.4	12.8	13.2	14.7	13.1
$300 or more	16.2	18.0	13.1	15.5	17.1	12.9	14.5	15.1	--
Collateral Required:									
No	14.2	17.1	13.1	13.4	16.2	13.3	12.1	13.7	13.6
Yes	15.6	17.6	13.4	14.1	16.7	13.5	13.0	15.0	13.1
Form of Business:									
Corporate	15.4	17.3	13.2	14.3	16.7	13.1	13.4	14.8	12.6
Partnership	13.7	18.2	13.1	13.9	17.0	13.7	11.0	13.4	13.6
Proprietor	14.3	17.2	13.5	13.3	16.2	13.9	12.3	15.3	13.8
Region:									
New England	16.3	17.1	12.9	13.7	17.0	13.2	15.4	15.4	13.6
Mid Atlantic	14.7	16.1	12.8	12.8	16.7	13.0	12.0	15.3	12.7
EN Central	14.6	17.0	13.2	14.4	17.0	13.1	13.9	14.3	14.0
WN Central	14.5	17.2	13.7	13.4	15.4	13.5	11.7	14.8	13.2
South Atlantic	14.4	16.9	12.8	13.0	15.2	13.7	13.2	16.9	12.3
ES Central	14.6	17.6	12.9	13.4	16.8	13.2	13.0	15.4	12.8
WS Central	14.6	17.6	13.1	13.8	16.4	13.2	12.9	14.6	12.0
Mountain	15.4	18.7	13.9	13.9	17.7	13.8	13.4	13.7	14.0
Pacific	15.9	17.9	13.5	15.3	17.0	13.8	11.7	14.4	13.3
Bank Asset Size: ($ million)									
Under 100	14.5	17.2	13.5	13.5	16.1	13.3	12.9	15.0	13.3
100-499	15.0	17.8	13.3	13.6	16.4	13.5	13.0	14.9	12.5
500 or more	15.8	17.2	13.2	14.5	16.9	13.5	12.9	14.1	13.3
Market Size:									
Rural	14.3	17.0	13.5	13.6	16.5	13.5	12.8	14.5	13.3
Small City	15.1	17.5	13.3	13.9	16.8	13.5	13.0	14.9	13.3
City	14.2	18.0	13.1	12.[illegible]	16.3	13.3	15.9	16.4	12.0
Metro.	15.4	17.7	12.9	14.[illegible]	16.7	13.5	13.2	13.4	12.5

Notes to Table 19

[a] Includes only those loans originated during the fourth quarter of 1979 and the first quarter of 1980.

[b] Includes only those loans originated during the fourth quarter of 1981 and the first quarter of 1982.

[c] Includes only those loans originated during the fourth quarter of 1983 and the first quarter of 1984.

Table 20

DEBT TO ASSET RATIO BY INTEREST RATE PAID (1984 SURVEY)

	Debt/Asset Ratio Within Each Interest Rate Group									
Interest Rate on Last Loan	No Debt[a]	Under 10%	10-19%	20-29%	30-39%	40-49%	50-59%	60-69%	70% or More	All Firms
Under-10.0%	35	23	11	9	2	9	4	3	4	100%
10.1-12.5%	13	26	17	15	7	7	3	5	7	100%
12.6-15.0%	9	18	15	15	11	10	9	6	7	100%
15.1-17.5%	8	33	11	10	10	8	3	4	13	100%
17.6-20.0%	9	22	18	7	13	7	11	2	11	100%
20.1 or more	9	*	25	8	17	25	8	8	*	100%
Total	22%	21%	13%	12%	8%	8%	5%	4%	7%	100%
Average Rate Paid	12.2%	13.2%	13.3%	13.1%	14.0%	13.6%	13.8%	13.3%	13.6%	

	Rate Paid Within Each Debt/Asset Ratio Group									
Interest Rate on Last Loan	No Debt[a]	Under 10%	10-19%	20-29%	30-39%	40-49%	50-59%	60-69%	70% or More	All Firms
Under-10.0%	27	9	7	6	2	9	6	5	4	9%
10.1-12.5%	29	35	33	33	21	23	17	32	29	30%
12.6-15.0%	33	36	45	51	58	52	63	52	44	46%
15.1-17.5%	7	16	8	7	11	9	6	7	17	10%
17.6-20.0%	3	4	5	2	6	3	7	2	6	4%
20.1% or more	1	3	2	1	2	4	1	2	*	1%
All Firms	100%	100%	100%	100%	100%	100%	100%	100%	100%	

[a] Includes firms that did not answer the question; "prefer not to answer" was a choice.

* Less than 0.5%

Mature firms (in business over 20 year) most frequently reported all needs met (57 percent compared to 43 percent for firms in business less than three years). Only four percent reported major credit needs unmet, down from five percent in 1982 and equal to the 1980 figure.

Virtually all of the lending activity covered in the 1980 survey occurred before the economy collapsed. Lending in that environment was "loose" and borrowing appeared "safe" and easy to repay. After economic activity collapsed and the inflation rate came down, lenders became much more cautious as the number of business failures began to rise.

Ninety (90) percent of all firms reported receiving 90 percent or more of their original loan request, up from 83 percent in the prior two surveys (Table 22). This suggests that credit may have become somewhat more available since 1982 (or that due to the failure of weaker firms or improved economic conditions, many riskier firms are no longer borrowing, eliminating from the borrowing pool firms that have more difficulty getting credit). Firms with steady or rising sales more often received the funds they desired, as did firms that had been in business a number of years (16 years or more). Firms with loans involving no collateral more frequently indicated that they received 90 percent or more of their original loan request. This suggests that one major function of collateral is to make the borrower "less risky," making it possible for the bank to make the loan or provide a higher percentage of the credit requested by the firm. Without collateral, the loan amount would be even smaller, the rate charged much higher or no funds would be advanced at all.

The proportion of firms reporting that credit availability problems had adversely impacted expansion plans fell from 44 percent in 1980 to 41 percent in 1982 and then to only 31 percent in 1984 (Table 23). New firms and firms with declining sales most frequently reported that difficulty in raising funds had impacted expansion plans.

Borrower satisfaction with loan terms remained unchanged from 1982. Seventy-two (72) percent reporting that they received the terms they originally requested (Table 24). Forty-three (43) percent reported that loan terms were "very satisfactory," up from 35 percent in 1982.

For those firms unsatisfied with their loan arrangement, 68 percent complained about interest rates charged, up from 63 percent in 1982 and only 49 percent in 1980, when other terms such as the size of the loan, its maturity and collateral requirements were of greater concern to borrowers (Table 25). In spite of the high interest rates that prevailed in 1980 period, small firms were borrowing at very favorable rates relative to market interest rates. By 1984, small business loan rates were much higher relative to

Table 21

CREDIT EXPERIENCE BY SELECTED VARIABLES

	Credit Needs Met:											
	All			Most			Some/Not			Major/Not		
	1980	1982	1984	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in Business:												
1-2	44%	37%	43%	29%	25%	28%	12%	16%	12%	8%	11%	11%
3-4	47	39	47	27	27	25	15	13	14	9	12	6
5-6	40	44	50	37	26	25	11	13	11	7	5	4
7-10	50	52	56	32	24	15	9	8	11	4	6	8
11-15	55	51	47	28	25	23	10	11	9	3	4	5
16-20	59	52	55	26	21	17	9	11	7	3	1	2
21 +	68	56	57	19	16	12	6	5	5	2	2	1
Business Activity:												
Rapidly Growing (21+%)	54	48	53	27	24	21	8	11	9	7	5	7
Growing (6-20%)	58	54	54	28	21	18	8	7	8	3	4	3
Steady(0-5%)	62	49	58	23	21	17	8	8	5	3	5	4
Decline	38	48	46	29	20	16	18	13	12	10	7	5
Too New	53	40	38	18	29	34	10	11	14	12	12	9
Collateral Required:												
Yes	47	49	50	31	25	21	12	12	11	5	6	5
No	66	53	55	20	16	14	6	6	4	3	3	3
Banks Used:												
1	59	53	63	25	20	17	8	8	8	4	5	3
2	49	47	52	31	23	25	11	10	9	5	5	7
3 or More	53	50	43	25	23	26	13	15	17	6	3	7
Active Solicitation:												
Yes	58	58	52	26	20	18	9	8	9	4	3	5
No	54	46	54	26	24	20	11	10	6	5	7	4
Bank Size: ($ Million)												
Less than 100	58	52	57	25	22	18	9	10	9	4	5	3
100-500	54	51	54	27	22	18	11	9	7	5	4	4
Greater than 500	52	49	50	29	21	18	9	8	8	5	7	7

Table 22 (Continued)

CREDIT AVAILABILITY BY SELECTED VARIABLES

	Percent of Initial Loan Request Granted								
	90-100%			50-89%			under 50%		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Collateral Required:									
Yes	85	85	87	8	3	7	3	10	6
No	80	81	94	2	2	3	2	3	3
All Firms	83%	83%	90%	5%	2%	5%	3%	7%	5%

* Less than 0.5%

Table 23

CREDIT AVAILABILITY EFFECT ON EXPANSION PLANS

	Yes			No			Don't Know		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in business:									
1-2	47%	46%	35%	35%	37%	53%	30%	15%	12%
3-4	54	49	43	32	37	50	21	13	7
5-6	51	43	32	35	42	65	21	17	3
7-10	47	42	31	40	46	64	26	20	10
11-15	43	32	35	47	48	55	28	20	10
16-20	43	32	31	42	51	65	27	23	4
21 +	35	32	24	51	52	71	35	25	5
No answer	43	17	20	38	56	76	33	22	4
Business activity:									
Rapidly growing (21+%)	45	41	32	44	48	63	27	21	5
Growing (6-20%)	45	34	30	43	49	66	28	25	4
Steady (0-5%)	36	37	25	49	44	69	34	18	6
Decline	63	42	37	26	41	54	15	16	9
Too new	39	44	32	35	40	48	37	19	20
No answer	22	37	28	47	39	69	44	19	3
Collateral Required:									
Yes	52	43	36	37	44	57	23	16	7
No	33	32	21	51	51	74	36	27	5
All Firms	44%	41%	31%	43%	47%	63%	7%	6%	6%

market interest rates such as the prime rate, possibly producing more dissatisfaction. Only a few percent of the borrowers perceived loan size, collateral requirements or maturity as unfavorable.

B. Loan Rejections

The loan rejection rate in 1980 was 13 percent (Table 26). It fell to 11 percent in 1982 and remained there in the 1984 study. The acceptance rate rose by one percentage point, making 1984 the best of the three reporting years in terms of acceptances and refusals. These figures suggest borrowers quality has improved. Rejections were most frequent among new firms and firms with rapid sales growth (Table 27). Refusals were again more frequent at branches of banks than at bank headquarters. This is difficult to interpret, however, as it is not known what the disposition of a refusal at a branch would have been if the loan had been processed at the main office. For banks with only one location, and there were many of these used by respondents, there are no branches. Thus, more rigorous examination of this phenomenon would require studying only banks that had branches, since by definition no firm can be refused a loan at a branch if the bank has none.

IV. BANK COMPETITION FOR SMALL FIRM BUSINESS

The proportion of firms reporting that one or more banks actively solicited their business during the past five years declined dramatically in the 1984 survey. In 1980, 37 percent of the borrowers reported that they had been contacted regarding their banking business. In 1982, the percentage had risen to 40 percent. But the 1984 figure fell to 27 percent (Table 28). In part, the decline in active solicitation may have been a result of the economic recovery. The economic recovery put many businesses back on their feet and improved their sales outlook. The expansion also generated immediate needs for cash, bringing business to the banks. Thus, the banks may have had less need to actively seek customers.

It is also possible banks may have become less willing to make loans to small firms. Small business failures rose to very high levels during the recession. The resulting losses left banks more reluctant to solicit small firm business, particularly with good alternatives available such as the opportunities provided by the rebound in consumer borrowing. These consumer loans became more profitable, as a majority of states removed or substantially increased the maximum rate of interest that could be charged on consumer loans. Heavy demands by the Treasury have also provided banks with the choice of large volumes of riskless "loans" to the government that have continued to provide a good rate of return. Thus, banks had alternative customers.

Nineteen (19) percent of the firms in markets served by one bank reported solicitation for their banking business in the last five years (Table 28). This percentage rose as the number of

Table 24

LOAN TERM SATISFACTION

Characteristics

	Percent of All Firms 1980	1982	1984
Years in Business:			
1-2	8%	6%	8%
3-4	12	10	8
5-6	10	9	8
7-10	16	16	17
11-15	12	12	14
16-20	10	9	10
21+	31	37	33
No answer	1	1	2
Business activity:			
Rapidly Growing(21%+)	10	14	12
Growing(6-20%)	47	39	38
Steady(0-5%)	27	21	23
Decline	11	19	20
Too New	2	4	4
No Answer	3	3	3
Collateral Required:			
Yes	56	56	59
No	44	44	41
All Firms	100%	100%	100%

	Received Originally Requested Loan Terms								
	Yes			No			Terms Given		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in Business:									
1-2	71%	66%	74%	16%	15%	11%	7%	15%	12%
3-4	74	65	68	11	14	10	10	18	6
5-6	67	72	76	12	9	9	14	15	12
7-10	77	73	68	8	10	10	10	12	16
11-15	75	73	68	12	9	9	8	11	18
16-20	74	80	79	9	8	6	9	7	8
21 +	75	71	73	7	8	5	7	11	10
No answer	67	56	76	14	*	*	9	17	17

Table 24 (Continued)

	Received Originally Requested Loan Terms								
	Yes			No			Terms Given		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Business activity:									
Rapidly growing (21%+)	75	71	70	14	11	13	8	10	13
Growing(6-20%)	76	75	72	10	10	8	8	10	18
Steady(0-5%)	74	71	71	7	8	6	11	14	12
Decline	71	69	73	14	9	6	8	15	13
Too new	75	66	72	10	15	11	10	15	14
No answer	49	66	78	6	4	4	6	12	11
Collateral Required:									
Yes	74	70	71	14	14	11	10	14	16
No	74	73	74	5	4	3	8	10	8
All Firms	74%	72%	72%	10%	10%	8%	9%	12%	12%

	Satisfaction With Loan Terms											
	Very Satisfactory			Satisfactory			Not Too Good			Unsatisfactory		
	1980	1982	1984	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in business:												
1-2	38%	32%	40%	35%	35%	40%	16%	23%	16%	4%	8%	2%
3-4	38	25	35	37	44	37	17	22	15	3	6	5
5-6	32	29	49	42	42	29	17	23	18	2	2	2
7-10	38	32	40	39	42	37	16	16	14	3	5	4
11-15	40	29	41	39	45	35	11	17	13	4	4	3
16-20	40	37	43	34	42	38	14	12	10	2	4	2
21+	48	41	47	31	35	29	9	12	10	3	2	1
No answer	38	33	41	29	17	41	14	22	7	9	6	*
Business activity:												
Rapidly growing (21%+)	41	32	45	32	40	30	17	19	16	4	3	2
Growing(6-20%)	42	38	44	37	39	35	12	15	11	3	3	2
Steady(0-5%)	44	34	46	35	41	30	12	15	11	1	3	2
Decline	31	32	38	34	39	37	21	19	13	7	4	3
Too new	43	32	32	35	40	48	12	14	15	6	11	2
No answer	26	33	49	25	30	27	8	15	13	3	7	2

Table 24 (Continued)

	Satisfaction With Loan Terms											
	Very Satisfactory			Satisfactory			Not Too Good			Unsatisfactory		
	1980	1982	1984	1980	1982	1984	1980	1982	1984	1980	1982	1984
Collateral Required:												
Yes	34	28	38	40	45	39	19	22	17	4	5	3
No	50	43	51	29	32	27	6	9	6	2	2	1
All Firms	41%	35%	43%	36%	39%	34%	13%	16%	13%	3%	4%	2%

Table 25

REASONS FOR LOAN TERM DISSATISFACTION BY SELECTED VARIABLES

	Reason for Dissatisfaction								
	Interest Rate			Amount			Maturity		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in business:									
1-2	42%	49%	60%	11%	10%	5%	11%	6%	5%
3-4	45	54	61	13	9	*	10	5	*
5-6	39	60	70	13	4	*	11	7	*
7-10	45	63	67	10	7	2	10	3	*
11-15	54	69	63	11	5	3	6	6	3
16-20	63	76	81	6	*	*	6	5	5
21+	53	67	73	8	4	*	11	9	2
No answer	64	78	75	*	11	*	27	*	*
Business activity:									
Rapidly growing (21%+)	42	64	73	11	5	3	9	6	*
Growing(6-20%)	49	62	65	9	6	*	10	4	2
Steady(0-6%)	50	70	69	10	3	*	11	7	2
Declining	51	63	70	12	6	4	9	7	2
Too new	48	62	58	8	7	*	16	7	*
No answer	43	57	88	7	5	*	7	11	*
Collateral Required:									
Yes	44	57	68	11	6	2	11	6	2
No	67	79	69	9	4	*	6	6	*
All Firms	49%	63%	68%	10%	6%	1%	10%	6%	2%

Table 25 (Continued)

REASONS FOR LOAN TERM DISSATISFACTION BY SELECTED VARIABLES

	Reason for Dissatisfaction								
	Collateral			Comp. Balances			Pers. Treatment		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in business:									
1-2	10%	14%	10%	*%	2%	*%	6%	7%	5%
3-4	14	12	4	1	4	*	4	5	*
5-6	14	14	*	1	1	*	5	4	4
7-10	18	12	4	1	3	2	5	4	2
11-15	11	10	*	2	*	*	4	3	*
16-20	12	8	5	2	4	*	2	1	*
21+	11	9	2	2	3	*	4	2	*
No answer	9	*	*	*	*	*	*	*	*

	Reason for Dissatisfaction								
	Collateral			Comp. Balances			Pers. Treatment		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Business activity:									
Rapidly growing (21%+)	14	10	3	1	3	*	2	3	*
Growing(6-20%)	12	12	2	1	4	1	5	3	1
Steady(0-5%)	12	10	4	1	2	*	4	3	2
Decline	14	12	4	2	1	*	3	5	*
Too new	4	10	*	*	1	*	4	2	8
No answer	21	8	*	*	*	*	7	5	*
Collateral Required:									
Yes	16	14	4	1	3	1	4	4	2
No	2	1	*	*	*	*	5	3	*
All Firms	13%	11%	3%	1%	2%	*%	4%	3%	1%

	Reason for Dissatisfaction								
	Time			Understand			Other		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Years in business:									
1-2	7%	6%	*%	7%	6%	*%	6	*%	*%
3-4	7	5	*	3	5	5	3	1	*
5-6	6	6	*	9	5	*	1	*	*
7-10	7	3	*	3	3	4	2	2	*
11-15	4	2	*	5	5	*	4	*	2
16-20	3	5	*	3	1	3	2	*	*
21+	4	3	*	6	2	5	2	1	5
No answer	*	*	*	*	11	*	*	*	*

Table 25 (Continued)

	Reason for Dissatisfaction								
	Time			Understand			Other		
	1980	1982	1984	1980	1982	1984	1980	1982	1984
Business activity:									
Rapidly growing (21%+)	8	4	*	8	4	3	5	1	*
Growing(6-20%)	5	3	*	6	5	2	2	1	*
Steady(0-5%)	6	2	*	4	2	*	2	1	*
Decline	4	3	*	3	2	2	2	1	4
Too new	4	5	*	8	5	*	8	1	*
No answer	7	8	*	4	6	*	4	*	*
Collateral Required:									
Yes	6	4	*	5	4	2	2	1	1
No	3	2	*	6	2	*	3	2	2
All Firms	5%	4%	*%	5%	4%	2%	3%	1%	1%

* Less than 0.5%

Table 26

REASON FOR LOAN REFUSAL

Reason	April 1980	April 1982	April 1984
Too New	13%	16%	15%
Too Much Debt	9	18	13
Lender Had No Money	27	9	5
Use Not Wise	8	4	3
Couldn't Repay	1	3	2
Low Equity	10	14	7
Poor Pay History	1	3	4
Weak Financial Statement	11	11	11
No Idea (Why Loan Refused)	10	12	12
No Answer	10	10	30
Total	100%	100%	100%
Total attempts*	2012	1849	1323
Total rejected	254	193	132
Total accepted	1709	1583	1145
Rejection rate	.13	.11	.11
Acceptance rate	.85	.86	.87

* Included those whose decision on the loan request is pending.

Table 27

CHARACTERISTICS OF ACCEPTED AND REJECTED FIRMS

				Last Loan Attempt								
	Distribution of All Firms			Accepted			Rejected			Don't Know		
Years in Business	1980	1982	1984	1980	1982	1984	1980	1982	1984	1980	1982	1984
1-2	8%	6%	8%	74%	62%	72%	21%	22%	15%	3%	7%	6%
3-4	12	10	8	74	75	85	20	21	12	5	4	3%
5-6	10	9	9	79	86	81	18	12	12	3	2	7%
7-10	16	16	17	85	83	84	13	12	12	2	5	4%
11-15	13	12	15	87	89	88	12	10	9	1	1	3%
16-20	10	9	11	89	84	85	9	12	11	2	4	4%
21+	30	36	30	92	91	92	7	6	6	2	4	2%
No Answer	1	1	2	89	100	84	6	*	4	6	*	12%
Business Activity:												
Rapidly Growing(21%+)	10	15	12	85	83	83	14	15	13	1	2	4
Growing(6-20%)	48	39	37	86	90	87	11	7	10	3	3	3
Steady(0-6%)	26	20	23	88	85	88	10	10	9	2	5	3
Declining	11	20	21	79	85	88	19	12	9	2	3	3
Too New	2	4	5	78	66	81	16	22	13	5	12	6
No Answer	2	3	2	61	81	81	29	15	17	9	4	2
Number of Times Borrowed in Year:												
Once	26	25	27	84	84	87	13	13	10	3	4	3
Twice	16	15	13	86	87	90	12	10	8	3	3	2
Three or more	24	22	19	88	92	89	10	6	7	2	2	4
No Answer	33	38	41	83	83	84	15	12	12	31	5	4
Loan Source:*												
Principal Bank-Hdqtrs.	87	58	71	86	90	90	12	7	8	2	3	2
Principal Bank-Branch		28	19		81	79		15	16		4	5
Other Bank	6	6	*	71	64	*	26	17	*	3	9	*
Use One Bank Only	3	4	8	90	88	89	3	5	4	7	7	7
No Answer	4	4	2	81	90	86	13	10	9	6	*	4
All Firms	100%	100%	100%	85%	86%	86%	13%	11%	10%	2%	4%	4%

* The 1980 survey did not separate the principal bank category into headquarters and branches.

* Less than 0.5 percent.

banks serving the market increased, reaching 34 percent for firms in markets served by eleven or more banks. But in all categories the incidence of contact was substantially below that reported in 1982. Firms in rural areas were contacted less frequently than firms in larger metropolitan areas where the number of banks serving the market is likely to be larger. Thus, even though the overall level of active solicitation may have declined, it continued to be more frequent in markets where there are larger numbers of banks.

Relatively few firms in markets served by only one bank reported any change in bank competition (Table 29). Clearly these banks are subject to the least competitive pressure as they face competition only from outside banks. These outside banks face competitive disadvantages because they are more difficult (and therefore more expensive) to deal with and have less information about the firm than the bank in the local market. Just nine percent of the firms in the "one-bank markets" reported signs of changes in competition, compared to 23 percent in markets served by two to ten banks. With eleven or more banks in the market, the frequency of reported improvements in bank competition jumped to 28 percent.

Overall, the proportion of firms reporting improvements in competition continued to rise, increasing from 20 percent in 1980 to 34 percent in 1984. Even though the frequency of direct solicitations for business fell substantially, however, firms felt that the degree of competition had increased substantially (perhaps taking other forms such as mail solicitation, advertising, etc.). Thus, there is some evidence that "deregulation" is improving the competitive environment for banking, at least from the perspective of small firms.

V. SMALL BUSINESS AND ITS BANKING RELATIONSHIPS

In all three surveys, firms were asked to characterize their desired banking relationship and to rate the performance of their primary bank in terms of the ten items listed in Table 30. All of the characteristics, with the exception of "Offers the Cheapest Money," represent non-price dimensions of a banking relationshp. Firms rated these items from "1" (very important) to "4" (not important) in their desired banking relationshp and then rated their own bank's performance on these items from "1" (good) to "4" (not good).

The overall findings have been consistent over the three studies. "Knows You and Your Business" received the highest proportion of "very important" citations (65 percent) of the ten items shown in Table 30. The second-highest number of top ratings went to "Reliable Source of Credit" (52 percent). "Offers the Cheapest Money" ranked third with 46 percent rating it as "very important" in a banking relationship. "Provides Helpful Business

Suggestions" (21 percent) and "Ideas to Improve Bank Service" (18 percent) were least frequently regarded as important to the desired banking relationship. These results suggest that the "consulting" aspect of the banking relationship is less important than continuity of credit availability and sensitivity to the particular problems and circumstances of the firm's business.

Table 28

ACTUAL BANK SOLICITATION WITHIN LAST FIVE YEARS
BY SELECTED VARIABLES

	1980		1982		1984	
	Percent of All Firms	Percent Solicited	Percent of All Firms	Percent Solicited	Percent of All Firms	Percent Solicited
Number of Banks in Community:						
1	8%	22%	8%	20%	6%	19%
2-3	28	30	26	34	25	22
4-5	24	39	25	41	24	26
6-10	18	45	20	48	27	31
11 or more	19	49	18	49	12	34
Community Size:						
Rural	40	29	41	30	43	23
Small City	30	43	30	42	30	28
City	19	46	20	51	17	34
Metropolitan	8	47	8	55	8	30
All Firms	100%	37%	100%	40%	100%	27%

* Less than 0.5 percent.

Table 29

NOTICE A CHANGE IN BANK COMPETITION
BY SELECTED VARIABLES

Characteristics	All Firms		
	1980	1982	1984
Banks in Community:			
1	8%	8%	6%
2-3	28	26	25
4-5	24	25	23
6-10	18	20	27
11 or more	19	18	12
Community Size:			
Rural	40	41	43
Small city	30	30	30
City	19	20	17
Metropolitan	8	8	8
All Firms	100%	100%	100%

	Change in Competition											
	Much More			More			Much Less			Less		
	1980	1982	1984	1980	1982	1984	1980	1982	1984	1980	1982	1984
Number of Banks in the Community:												
1	6%	3%	3%	8%	9%	9%	4%	6%	1%	2%	*%	1%
2-3	6	8	7	12	15	23	6	6	3	3	3	1
4-5	6	8	13	16	19	23	7	7	3	2	3	2
6-10	9	14	14	12	18	23	8	7	3	2	3	2
11 or more	8	14	18	13	20	28	10	5	5	3	2	2
Community Size:												
Rural	7	7	7	10	14	21	6	5	3	3	2	1
Small City	8	10	15	16	19	21	7	7	3	2	2	2
City	7	11	16	12	20	25	11	7	2	1	3	1
Metropolitan	8	22	18	16	15	23	6	7	5	2	2	1
All Firms	7%	10%	12%	13%	17%	22%	2%	3%	3%	7%	6%	2%

Ratings of bank performance differed markedly from rankings of the characteristics of desired relationships. Banks most frequently received top marks on accessibility ("Convenient Location," 55 percent, and "Easy Access to Loan Officer," 49 percent). Forty-eight (48) percent gave their banks "good" (the top rating) scores on "Reliable Source of Credit" and "Wide Range of Business Services." "Knows You and Your Business," top-rated in the

TOP FIVE CHARACTERISTICS

Characteristic	Percent Rating Characteristic "Very Important"
Knows You and Your Business	65%
Reliable Source of Credit	52%
Offers the Cheapest Money	46%
Easy Access to Loan Officer	41%
One Person Handles Credit Needs	39%

desired banking relationship, received a top rating from 44 percent of the firms. Banks received poor marks on "Provides Helpful Business Suggestions" (17 percent), "Knows Your Industry" (21 percent) and "Ideas to Improve Bank Service" (13 percent). However, these three items ranked equally low in the "desired relationship."

The largest divergence between the percent rating an item as "very important" and the percent giving their own bank a top rating ("good") occurred for "Offers the Cheapest Money." Although only 46 percent gave it a top rating in their desired relationship, just 21 percent gave their bank a "good" rating in terms of actual performance, a difference of 25 percentage points (Table 31). This gap is due in part to the difference between the prime rates charged on small business loans, a difference that is much larger now than in 1982 or 1980.

The next largest "performance deficit" occurred for the most important item in the desired banking relationship, "Knows You and Your Business." Sixty-five percent rated this characteristic as "very important," but only 44 percent gave their own banks a top rating, a "gap" of 21 percentage points. The spreads are large and positive for items such as "Convenient Location," rated as important by very few firms, but receiving a number of "good" performance marks. Expanding the analysis to include "important" ratings in the desired relationship and "above average" in the performance score worsens eight of the ten differences between the desired and actual scores. "Offers the Cheapest Money" and "Knows You and Your Business" become somewhat less negative, but the performance gap remained very large and comparable to their values in previous surveys.

Banks in rural area continued to get better performance marks than their counterparts in larger cities or metropolitan areas, particularly on items of importance to the desired banking relationship (Table 32). For "Knows You and Your Business," 51 percent of the firms in rural areas gave their banks a "good" rating. However, this percentage falls to 35 percent in the "City" and 39 percent in the "Metropolitan" markets. Similarly, for "Offers the Cheapest Money," top ratings fell from 24 percent in rural areas to 16 percent in Metropolitan markets. As a "Reliable Source of Credit," 54 percent of the rural banks got top scores, compared to 41 percent in Metropolitan markets. Only for "One Person Handles Credit Needs" did banks in Metropolitan areas get top scores as often as banks in rural areas, a result consistent with earlier surveys.

Table 30

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation					
	Very Important/ Good*			Important/ Above Average*		
Characteristics	1980	1982	1984	1980	1982	1984
Knows You and Your Business						
Desired Characteristic	67%	68%	65%	21%	22%	23%
Actual Peformance	46	46	44	28	29	29
Provides Helpful Business Suggestions						
Desired	24	21	21	32	33	33
Actual	20	18	17	25	27	25
Offers the Cheapest Money						
Desired	47	50	46	28	30	32
Actual	26	22	21	33	34	36
One Person Handles Credit Needs						
Desired	40	40	39	35	37	37
Actual	44	44	44	30	32	31
Convenient Location						
Desired	39	30	31	37	39	36
Actual	52	55	55	28	27	28
Easy Access to Loan Officer						
Desired	na	42	41	na	41	40
Actual	na	50	49	na	32	32
Reliable Source of Credit						
Desired	54	55	52	30	31	34
Actual	46	48	48	29	28	28
Knows Your Industry						
Desired	29	27	24	37	32	35
Actual	24	21	21	27	29	29

Table 30 (Continued)

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP
AND PRINCIPAL BANK PERFORMANCE

Characteristics	Respondent Evaluation: Very Important/ Good* 1980	1982	1984	Important/ Above Average* 1980	1982	1984
Ideas to Improve Bank Service						
Desired	19	17	18	33	34	35
Actual	14	15	13	21	23	21
Knows Your Financial Needs						
Desired	34	na	na	38	na	na
Bank	26	na	na	31	na	na
Wide Range of Business Services						
Desired	34	32	31	38	42	43
Actual	42	47	48	33	32	34

Table 30 (Continued)

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP
AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation: Not Very Important/ Below Average* 1980	1982	1984	Not Important/ Not Good* 1980	1982	1984	No Answer 1980	1982	1984
Knows You and Your Business									
Desired Characteristics	3%	3%	3%	1%	2%	2%	8%	6%	7%
Actual Peformance	12	13	15	5	5	4	9	7	8
Provides Helpful Business Suggestions									
Desired	20	24	24	11	13	12	12	9	10
Actual	27	28	29	15	17	16	13	11	13
Offers the Cheapest Money									
Desired	9	8	8	4	3	4	12	9	10
Actual	15	21	21	11	12	9	14	12	13
One Person Handles Credit Needs									
Desired	11	11	12	4	4	3	11	8	9
Actual	8	8	8	6	5	4	12	10	13

Table 30 (Continued)

DESIRED CHARACTERISTICS IN A BANKING RELATIONSHIP
AND PRINCIPAL BANK PERFORMANCE

	Respondent Evaluation: Not Very Important/ Below Average* 1980	1982	1984	Not Important/ Not Good* 1980	1982	1984	No Answer 1980	1982	1984
Convenient Location									
Desired	11	20	18	3	6	5	10	7	8
Actual	6	7	5	3	2	2	11	9	10
Easy Access to Loan Officer									
Desired	na	6	6	na	3	3	na	8	10
Actual	na	[illegible]	5	na	4	3	na	10	11
Reliable Source of Credit									
Desired	3	4	3	2	2	2	11	8	9
Actual	8	9	8	5	5	4	12	10	12
Knows Your Industry									
Desired	19	23	23	7	9	7	13	10	11
Actual	22	24	24	13	15	12	15	12	14
Ideas to Improve Bank Service									
Desired	23	26	26	11	12	10	14	11	11
Actual	27	26	30	22	24	21	15	13	15
Knows Your Financial Needs									
Desired	10	na	na	5	na	na	13	na	na
Actual	18	na	na	11	na	na	14	na	na
Wide Range of Business Services									
Desired	12	15	14	4	3	3	12	8	9
Actual	8	8	6	5	3	1	12	10	11

* "Very Important," "Important," "Not Very Important," and "Not Important," are evaluations of desired characteristics. "Good," "Above Average," "Below Average," and "Not Good," are evaluations of actual performance.

na Not asked

VI. SUMMARY AND CONCLUSIONS

New firms tend to be relatively risky and small. This has limited the role of institutional suppliers of capital (either investors or lenders) such as banks in financing small business starts.

But once established, small firms rely most heavily on the banking system as a source of funds. Banks provide 85 percent of all loans and 90 percent of all short-term loans to small businesses. The role of government financing is inconsequential. Although other lending institutions such as S&Ls and credit unions have new lending powers that permit loans to small firms, no change in the market share of such institutions was apparent from the 1984 data. These institutions do not have the experience nor the expertise to quickly enter this market, and they have not done so. Thus, banks can be expected to continue to dominate the small business loan market, although they will face growing competition for this market in the future.

Table 31

DESIRED CHARACTERISTIC MINUS ACTUAL PERFORMANCE DIFFERENCES*

	Very Important/ Good			Very Important & Important/Good & Above Average		
Characteristics	1980	1982	1984	1980	1982	1984
Knows you and your business	-21	-22	-21	-14	-15	-15
Provides helpful business suggestions	-4	-3	-4	-11	-9	-11
Offers the cheapest money	-21	-18	-25	-16	-24	-21
One person handles the credit needs	4	4	6	-1	-1	-1
Convenient location	13	25	24	4	13	15
Easy access to loan officer	na	8	8	na	-1	-1
Reliable source of credit	-8	-7	-4	-9	-10	-9
Knows your industry	-5	-6	-3	-10	-9	-10
Ideas to improve service	-5	-2	-5	-17	-13	-18
Knows your financial needs	-8	na	na	-15	na	na
Wide range of banking services	8	15	17	0	0	8

* In percentage points.
na Not asked

Table 32

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

	Community Size					
	Rural[a]			Small City[b]		
Characteristics	1980	1982	1984	1980	1982	1984
Knows You and Your Business						
Good	51%	41%	51%	49%	45%	41%
Good + above average	77	79	78	76	74	71

Table 32

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

	Community Size					
	Rural[a]			Small City[b]		
Characteristics	1980	1982	1984	1980	1982	1984
Provides Helpful Business Suggestions						
Good	23	20	21	21	17	15
Good + above average	48	45	45	45	45	42
Offers the Cheapest Money						
Good	29	23	24	27	22	21
Good + above average	60	54	59	62	57	55
One Person Handles Credit Needs						
Good	45	46	46	44	44	44
Good + above average	76	79	79	76	75	73
Convenient Location						
Good	56	59	60	51	54	55
Good + above average	81	86	86	82	84	85
Easy Access to Loan Officer						
Good	na	52	54	na	48	47
Good + above average	na	83	84	na	81	80
Reliable Source of Credit						
Good	51	52	54	46	47	47
Good + above average	77	78	82	77	76	75
Knows Your Industry						
Good	28	24	27	23	20	18
Good + above average	55	53	55	52	48	47
Ideas to Improve Service						
Good	15	16	15	16	13	12
Good + above average	37	37	35	36	36	33
Knows Your Financial Needs						
Good	29	na	na	26	na	na
Good + above average	61	na	na	58	na	na
Offers Wide Range of Banking Services						
Good	42	50	50	45	46	49
Good + above average	74	79	84	78	83	82

Table 32 (Continued)

MAJOR BANK PERFORMANCE BY COMMUNITY SIZE

	Community Size					
	City[c]			Metropolitan[d]		
	1980	1982	1984	1980	1982	1984
Knows You and Your Business						
Good	38%	37%	35%	41%	44%	39%
Good + above average	70	69	70	73	74	66
Provides Helpful Business Suggestions						
Good	16	15	13	17	17	12
Good + above average	38	42	42	46	45	38
Offers the Cheapest Money						
Good	22	21	18	23	19	16
Good + above average	57	58	61	62	56	51
One Person Handles Credit Needs						
Good	42	42	41	47	45	47
Good + above average	71	73	72	76	77	73
Convenient Location						
Good	51	54	49	49	46	42
Good + above average	79	80	82	79	74	76
Easy Access to Loan Officer						
Good	na	49	46	na	52	47
Good + above average	na	81	82	na	85	75
Reliable Source of Credit						
Good	42	45	42	43	44	41
Good + above average	74	74	74	76	77	68
Knows Your Industry						
Good	19	17	15	17	17	15
Good + above average	44	46	46	49	52	46
Ideas to Improve Service						
Good	10	13	11	13	15	9
Good + above average	32	40	37	35	38	32
Knows Your Financial Needs						
Good	21	na	na	25	na	na
Good + above average	52	na	na	57	na	na
Offers Wide Range of Banking Services						
Good	43	46	46	42	46	45
Good + above average	78	79	86	79	77	77

Notes to Table 32

a Up to 15,000 population
b 15,000 to 100,000 population
c 100,000 to 1,000,000 population
d Over 1,000,000 population
na Not asked

Virtually all firms borrow at some time during their existence. Over half borrow at least once per year, primarily from a bank. The proportion of regular borrowers (at least once per year) has declined continually since the first study in 1980, while the number of infrequent borrowers has risen. This change reflects an abatement of the adverse impact of high inflation on borrowing activity. Inflation impairs cash flow and forces firms to borrow when interest rates are highest. With the recovery, borrowing activity has subsided substantially. The percentage of borrowers has fallen from over 50 percent in the late 1970s to about 40 percent in 1984 (38% is the lowest percentage of borrowers recorded). Low and stable inflation coupled with strong demand have left firms with stronger cash flow positions and a reduced need to borrow. The real cost of funds has also risen substantially, as nominal rates have remained high even when the rate of inflation had subsided substantially. The resulting high real rates have discouraged some borrowing and induced firms to manage cash and inventories more carefully than they might have ordinarily.

The average interest rate paid on short-term loans by small firms was typically several points above the prime rate during the 1982-84 period. However, when the prime rate was high and rising such as in the late 1970s and early 1980s, most small firm borrowers paid rates below the posted prime rate. It appears that when market rates are falling, small firms tend to pay relatively higher rates. When rates are rising, small firm loan rates tend to lag the market. Historically, this has resulted from a relatively low incidence of loan contract rates tied to a market rate. However, in recent years, an increasing percentage of small business loans have been tied to the prime rate.

Well over half of all small business borrowers indicated that all of their credit needs had been met. Ninety (90) percent reported that they had received virtually the entire amount they had requested (a substantial increase from 1980 and 1982). Over 70 percent reported that they received all of the loan terms originally requested, and over 70 percent said they were satisfied with their loan terms. Satisfaction with loan arrangements was higher in 1984 than in the prior two survey years.

The CHAIRMAN. Thank you very much, gentlemen. All of you made very thoughtful and helpful statements.

Mr. Evans, it's been argued that the ownership of depository institutions by large diversified corporations—you mentioned Ford and, of course, Prudential Bache and others—strengthens that institution by providing a source of outside capital and managerial expertise. Would you agree with that?

Mr. EVANS. Yes.

FEDERAL DEPOSIT INSURANCE

The CHAIRMAN. All right. Now I'd like to refer you to page 3 of your statement, where you say that one of the aims of banking legislation should be to eliminate Government protections where they are necessary—where they are not necessary, I should say. Since you have such a deep and abiding faith in the marketplace, I wonder whether you would be willing to eliminate any governmental protection for nonbank banks, such as Federal deposit insurance. After all, if you have got the Ford Motor Co. behind you or Prudential Bache, why do you need the Federal deposit insurance?

Mr. EVANS. Well, the answer is obvious to that, Mr. Chairman. If we are going to compete on the same basis as the banks across the street, we've got to have Federal deposit insurance. Now if you want to eliminate it for everybody, that's fine with us.

The CHAIRMAN. Well, you're not competing on the same basis as banks. You don't have anything like the same limitations for a nonbank bank that you have with the banks. The banks aren't allowed to get into any number of other industries, including insurance, including brokerage, and so forth. I think they should be restricted. At any rate, they are. But the nonbank bank, of course, is in all kinds of things; isn't that right?

Mr. EVANS. The bank is not. The owners of the banks are. And that's the question as to whether we are going to have to regulate the owners of banks as the Bank Holding Company Act presently does, or whether we're going to allow diversified ownership and new capital.

The CHAIRMAN. Mr. Heuer, in your written testimony, you make many claims about how bank entry into insurance, particularly life insurance, would reduce the costs of insurance to consumers. The record of the banking industry in this area of credit life insurance, very high premiums, failure to refund unused portions of premiums and the apparent absence of competitive benefits and, of course, the enormous advantage banks have, because the loan officer also often is the person who sells and gets much of the premium for selling credit life insurance. If you want that loan, you'd better take the insurance. That seems to me to undermine your claim of consumer benefits.

And regarding low premiums charged by the New York savings banks, they may be lower, but those institutions are also mutually owned, and you and I know very well that the behavior of mutual and stock companies is very different.

Why do you not cite the premium charges of stockholder-owned banks in those States that permit banks to sell and underwrite life insurance, such as North Carolina, or the premium charges of banks selling insurance under title VI of the Garn-St Germain Act? I suggest that there is a very good reason you do not. The premiums are no lower than those offered by insurance companies. It seems to me if you have evidence on credit life insurance premiums or nationwide evidence on ordinary life insurance premiums that would counter what I suspect is true, I would like to see it. If not, I'd——

Mr. HEUER. Mr. Chairman, I do not have the kind of data that you ask for with me this morning, but I would be happy to submit it to you. We do have very interesting numbers on the premiums charged by those banks that have grandfathered insurance powers, that I would be pleased to submit, as well as the States that do empower their mutual savings banks to sell life insurance and compare their premiums with others. I think the issue of credit life insurance is somewhat different, because it is—it is true that the banks enjoy an advantage, although I know of no instances where banks have been accused of any tie-in arrangements in credit life, in extending credit.

The CHAIRMAN. It doesn't have to be very subtle. You are talking to a loan officer, and he says, do you want credit life insurance, and you fear that whether you get the loan or not hangs in the balance.

Mr. HEUER. I would be pleased to submit to you evidence that less than half of the customers that borrow take credit life insurance, which is some indication of the lack of any kind of coercion.

The CHAIRMAN. Well, also the lack, perhaps of aggressiveness on the part of the banks.

Mr. HEUER. That may also be true.

The CHAIRMAN. Mr. Motley, in your testimony, you urge the Congess to swiftly close the nonbank bank loophole, noting among other concerns that the greater concentration in banking that that loophole is bringing about may likely lead to a drop in entrepreneurial activity. Mr. Kuthy, of the Conference of State Bank Supervisors, noted yesterday that the greater concentration of economic power made possible by the nonbank bank loophole could have harmful political effects as well.

Do you share that view, and if so, why, and would a decline in small business have repercussions in our political system?

Mr. MOTLEY. I think a decline in small business would certainly have repercussions in our political system, Mr. Chairman, because I guess I tend to view small business as the last great American safety valve. It is something that everybody can do. All you need is a few dollars, an idea and a garage or a basement to start in, and you may end up being your own boss someday. There is mounting evidence, as you see from our testimony that in those countries that have tremendously concentrated banking systems, there is a decided lack of entrepreneurial activity, whereas in those countries where there is decentralized banking system, such as the United States and Italy, there is a growing entrepreneurial activity.

The English have sent at least three groups of people over here in the last 2 years to try and find out why we have this tremendous growth of entrepreneurial activity in the United States. And one of the conclusions that they have reached is that there is a significant difference in the banking systems, that the English system is terribly concentrated and is not willing to take a great deal of risk, whereas our system is supplying the needs of small business in this country.

The CHAIRMAN. Thank you very much. My time is up. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Unfortunately, I have to go, due to a conflict, but I did want to express my regret at not being here for the next panel as well, which has on it a distinguished Rhode Islander, Mr. William Irons, who, in addition to being very active in the insurance industry, is a State senator and a deputy minority leader, and everything about him is virtuous, except possibly his choice of party. [Laughter.]

The CHAIRMAN. That is virtuous, I am sure. [Laughter.]

Senator CHAFEE. He is chairman of the National Association of Life Underwriters Financial Institutions task force, and he is here representing a group of associations. And so I just want to extend my welcome to Senator Irons and say how glad we are that you're here.

The CHAIRMAN. Thank you very much, Senator Chafee.

Senator Graham, in view of the fact that Senator Chafee did not question, I'm going to call on Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Evans, you're filling in for Mr. Ford from Security Pacific Corp.

Mr. EVANS. That is true.

Senator HECHT. Are you with Security Pacific?

Mr. EVANS. No, I am president of the trade association of which Security Pacific is a member.

BIG BANKS DO A GREAT SERVICE TO SMALL BANKS

Senator HECHT. I see. Mr. Motley, you mentioned that small banks are so important to small business in America, which I wholeheartedly agree, and sometimes Senate panels are very antagonistic. I think sometimes you should go the other way and point out, when big banks do a great service to small businesses. And Security Pacific, I can speak on a first-hand basis, because of the correspondent services of small banks in the West has helped small business immeasurably, because the small banks cannot get along without the correspondent services, the bond advice, participation on loans, computer help, right on down the line. And I think that should always be brought out, the tremendous reliance small banks have on their major correspondent banks. So I hope you will pass that on, Mr. Evans.

Mr. EVANS. Thank you.

Senator HECHT. Mr. Heuer, you mentioned that you feel that we should address ourselves to the comprehensive banking legislation, perhaps the largest since the 1930's or in 50 years. Would you expand on that, please?

Mr. HEUER. Well, essentially, we think the direction is that of the financial services holding company which the Association of Bank Holding Companies described yesterday and is dealt with in our written testimony. It would essentially open up the financial services world to all who would want to compete but segregate the different business lines and regulate along function lines, requiring everybody in those business lines to play by the same rules, to be regulated by the same folks and, therefore, to compete on a level playing field basis. We think that the consumers of financial services will benefit from that free and open competition and that our country and our banking system will be stronger for it.

So our view is very much one of free open competition, as long as everybody has to play by the same rules.

Senator HECHT. In other words, a comprehensive banking bill, not the Band-Aid approach. Is that what you are trying to say?

Mr. HEUER. That is precisely right.

Senator HECHT. You mean, after 50 years, it is time?

Mr. HEUER. Yes, we certainly think it is. [Laughter.]

Senator HECHT. OK. How do you feel about that, Mr. Motley?

Mr. MOTLEY. We would certainly think that it is time also, Senator. Our only problem is that we're really not too confident that the Congress can handle it in the period of time that it needs to be done. Therefore, we would like to see the nonbank bank issue handled first.

Senator HECHT. Well, certainly, our distinguished chairman has hit the ground running, and we have 2 years, and we can do an awful lot in 2 years.

Do you have any type of legislation proposed for your association, beside the nonbank bank loophole?

Mr. MOTLEY. No, we do not, Senator.

Senator HECHT. Have you addressed this with members of your association?

Mr. MOTLEY. We have addressed it only in the sense of trying to determine the relationship of the members of the small business community with the banking community, and it is a area that we find a great deal of interest and concern and need within the small business community. But not being experts in the area ourselves, we don't feel that we are quite capable on expressing to you the way we think the industry should be restructured or the legislation should be presented.

Senator HECHT. I would be happy if you asked your members and report back to us. I'd just like to get their viewpoints on this.

Mr. MOTLEY. I would be glad to work you in putting together something, either to a sampling of the membership nationwide or possibly within your own State, if you'd like to do it.

Senator HECHT. Thank you very much. No further questions.

The Chairman. Thank you very much. Senator Graham.

Senator GRAHAM. Mr. Chairman, I would like to ask Mr. Evans a question. Do most of the institutions that your association represents that would be described as nonbank banks, are they in that category because they accept deposits but do not do commercial loans or vice versa?

Mr. EVANS. Well, there are many members of our institutions that do not own nonbank banks—do not own them, but the ones that do, do generally have them as so-called consumer nonbank banks. In other words, they are not taking deposits, but they are rendering consumer services, or they may be taking deposits and rendering consumer services, generally not doing it on the commercial side.

Senator GRAHAM. They are generally not——

Mr. **Evans**. Not doing for commercial lending purposes.

Senator **Graham**. They are accepting deposits, but they are not making commercial loans?

Mr. **Evans**. They may be, yes. They may be, yes. They may be accepting deposits, and although it has not been a tremendously large aspect of their operations, unless you want to characterize the nonthrift thrift as a consumer bank, in which case, yes, deposit taking is a very large part of it.

DIVERSION OF FUNDS

Senator **Graham**. I gathered from the comments of Mr. Motley that one of the reasons for their concern, the independent businesses on the nonbank bank, is the diversion of funds which might otherwise be available for commercial loans to the businesses that he represents.

What would be your response to that concern?

Mr. **Evans**. Well, this complaint goes back many, many years, Senator Graham, and I think an analogy can be drawn with the antichain store legislation that was urged in the 1920's and 1930's. In fact, Congressman Patman introduced a bill in 1938, which was called a "chain death sentence" bill, and it would have taxed all chain stores, such as Safeway, Sears, Penney's, Exxon—or rather than Standard Oil—out of existence. In fact, in 1940, the bill was finally killed in committee, it would have taxed J. C. Penney $64 million on about $16 million of net revenue. That was an unabashed attempt by Congressman Patman to put them out of business. And one of the strong reasons that was given by many of the proponents of this restrictive legislation was that chains would come to town and take money out of the town and send it back to Chicago and New York and all the big money centers and not put it back into the community, which, of course, we found to be untrue.

Many of the old canards that were dragged out and urged before the chambers and the halls here in Washington of this Congress have been revived in support of closing the nonbank bank loophole, which is very mysterious, because it's just the other way round. We're offering more competition, more funds, and a history, if you will, by the people who are involved in this of providing funds to the community. They lend heavily to business. And I would have to disagree with my learned colleague on the left.

Senator **Graham**. Mr. Motley, what would be your response to that statement and what has been the experience of your members in terms of the availability of financing through nonbank banks?

Mr. **Motley**. To answer the latter part of your question, first, Senator Graham, I really don't have any information at this point in time as to the availability of financing through nonbank banks.

What bothers us to a great extent, though, is that if you look at the applications that have been approved already or are pending, two-thirds of them are for nonbank banks that will accept deposits and make consumer loans only and not commercial loans. Therefore, we see in that trend or in those numbers, a lessening of the amount of credit which would be available to small business. It's a trend we don't like. Of the third which are there and giving commercial loans, if you simply tend to break out the way credit is divided between larger businesses in this country, small or local businesses, if you look at the way it is divided through large money center banks versus local banks, that also bothers us. So we see a lessening of the amount of credit available to smaller firms, if this trend continues.

Senator GRAHAM. Mr. Heuer, you talked about some of the fundamental things that occurring domestically, such as the Iowa farmers' concern relative to interstate banking, the impact of a unit banking system on their ability to get credit, and then the effects that are coming from outside the United States through the internationalization of capital markets.

What would be your vision of what we should be striving to accomplish, say, by the year 1990 or the year 2000, in terms of a reformed financial system for America to respond to domestic and international new realities?

Mr. HEUER. Senator, our vision of the direction that would foster safety and soundness and competitiveness, domestically and internationally, of our banking system, would be along the lines that I talked about in my oral comments, which was essentially to open up the financial services industry and not try to protect individual segments, but open it up to all would-be competitors, to maximize the offerings, the competition and the consumer pricing in the marketplace. I think that the free, open competition will lead to the strongest kind of financial service system in our country.

So we are—you know, the guiding principles of our association are parity, competitive parity and consumer benefit, and that's why we are supporting the proposals that point in that direction at this time.

I don't know if that answers your question.

Senator GRAHAM. Thank you.

The CHAIRMAN. Thank you very much, Senator Graham.

Well, gentlemen, thank you so much. I might just conclude by pointing out—oh, I beg your pardon. I thought you had questioned.

Senator HEINZ. Not yet.

The CHAIRMAN. You ask such excellent questions, that I thought you'd already finished. Go right ahead.

[Inaudible.]

Senator HEINZ. Is that a hint, Mr. Chairman?

The CHAIRMAN. Well, I'm sorry. We neglected our star, Senator Heinz.

Senator HEINZ. No, I stepped out of the room, but I thank you, Mr. Chairman.

Let me ask Mr. Evans. Mr. Evans, Mr. Motley gave a very effective statement as to why consumer banks pose some risk to the availability of credit to the business firms. Do you have anything you want to say in rebuttal? It seemed to me that Mr. Motley made a very good point.

CONSUMER BANKS PROVIDE CREDIT TO SMALL BUSINESSES

Mr. EVANS. Well, I think it flies in the face of reality. More competition, not less is what provides more credit. If there's a demand for business credit out there, it will be provided. Many of our mem-

Competition (or perceptions of competitive behavior) in lending markets seems to be increasing. Thirty-four (34) percent of all firms reported more bank competition, up from 20 percent in 1980 and 27 percent in 1982. Thus, more firms are sensitive to increased competition. However, the number of direct contacts by banks in an attempt to solicit firm business fell substantially from 1982 to 1984. This probably reflects the increased loan demand from both consumers and businesses due to the recovery and the very high failure rate for small firms during the recession. There may be more competition in the market generally, but direct competition for small business customers seems to have diminished somewhat.

Satisfaction with the banking relationship did not change appreciably from either 1980 or 1982. Firms continued to rate "Knows You and Your Business" as the most important characteristic of a banking relationship, but most did not give their banks a top performance rating on this count. Banks were rated much more poorly on delivering the "Cheapest Money Available," most likely because market interest rates have declined faster and farther than rates paid by small firms. Small firms gave their banks better ratings when interest rates were high because, in comparison, rates paid by many small businesses were relatively low (as many as 60 percent were below the prime). Banks did best in providing those services not dependent on a good personal relationship between bank personnel and the owner of the firm.

The small business loan market will probably grow in importance to the banking community as more large firms enter the capital markets directly for their financing needs and new competitors extend their reach into traditional bank markets. Overall, the relationship between the bank and the small firm appears to have been a good one. But, there are some area in need of improvement, particularly where personal services are involved. These deficiencies represent opportunities for competitive lending institutions to establish a share in the small business market.

NOTES

1/ Dunkelberg, W.C. and Scott, Jonathan A., Report on the Representativeness of the National Federation of Independent Business Sample of Small Firms in the United States, mimeo, Small Business Administration grant #SBA2A-00084-01, Purdue University, West Lafayette, Indiana.

2/ Legler, John B. and Hoy, Frank, Building a Comprehensive Data Base on the Role of Small Business in the U.S. Economy, Heller Institute for Small Business Policy Papers, 1982.

CREDIT, BANKS, AND SMALL BUSINESS

1. What is your form of business organization?
[1] ___ Proprietorship [2] ___ Partnership [3] ___ Corporation 1

2. Please classify **your major business activity,** using **one** of the categories of examples below: (If more than one applies, circle the **one** which contributes the most toward your **gross sales** or total revenues.)
[1] ___ Construction. (building contractors-general, painting, carpentry, plumbing, heating, electrical, etc., highway and bridge contractors; swimming pool construction; **etc.**)
[2] ___ Manufacturing (including dairy processor, printer, publisher, **etc.**)
[3] ___ Transportation, communication, public utilities (truckers, movers, broadcasters, **etc.**)
[4] ___ Wholesale (including grain elevator, livestock dealer, distributor of construction equipment, manufacturer's representative, **etc.**) 2
[5] ___ Retail (including food store, service station, restaurant, bar, radio and TV store, drug store, furniture and appliances, auto dealer, florist apparel, **etc.**)
[6] ___ Agriculture, forestry, logging, fisheries, **etc.**
[7] ___ Financial: insurance, real estate, bank, savings and loan, **etc.**
[8] ___ Beauty salon, barber shop, garage, motel, hotel, repair service, travel agency, bookkeeping service, photographer, funeral director, rental agency, credit bureau, laundry, **etc.**
[9] ___ Physician, dentist, attorney, optometrist, engineer, architect, veterinarian, accountant, skilled nursing care facility, **etc.**
[10] ___ Other (please describe) ____________________

3. During your last fiscal year, what were your **gross sales,** or revenues, net of sales taxes, and other excise taxes?
[1] ___ Under $50,000 [4] ___ $200,000-349,000 [7] ___ $800,000-1,499,999
[2] ___ $50,000-99,999 [5] ___ $350,000-499,999 [8] ___ $1,500,000-2,999,999 3
[3] ___ $100,000-199,999 [6] ___ $500,000-799,999 [9] ___ $3,000,000 or more

4. How many employees do you have **including** yourself?
[1] ___ Full-time employees [2] ___ Part-time employees 4-6 7-9

5. How long have you been in your present business? ________ years 10-11

6. Which of the following **best** describes your average annual dollar volume **sales growth** over the past 2 or 3 years? (Check **one** only.)
[1] ___ Declined [4] ___ 11 - 20% [7] ___ Too New in Business to Compare 12
[2] ___ 5% or Less [5] ___ 21 - 49%
[3] ___ 6 - 10% [6] ___ 50% or More

7. Considering the credit needs of your firm, what is your experience in getting business credit? (Check one only)
[1] ___ All credit needs were met [3] ___ Some credit needs were not met [5] ___ Don't need outside credit 13
[2] ___ Most credit needs were met [4] ___ Major credit needs were not met

8. When was the **last time** you got a loan for your business? (Circle the month and year)

Month				Year	
[1] ___ Jan	[5] ___ May	[9] ___ Sep	14-15	[1] ___ 1984	[5] ___ 1980
[2] ___ Feb	[6] ___ Jun	[10] ___ Oct		[2] ___ 1983	[6] ___ 1979
[3] ___ Mar	[7] ___ Jul	[11] ___ Nov		[3] ___ 1982	[7] ___ 1978
[4] ___ Apr	[8] ___ Aug	[12] ___ Dec		[4] ___ 1981	[8] ___ 1977 or before

OR ______ Too long ago to remember 16

8a. Where did you get your most recent business loan?
[1] ___ Bank (full service) [4] ___ Finance company [7] ___ Credit Union
[2] ___ Bank Loan Office (no deposits taken) [5] ___ Insurance company [8] ___ Savings and Loan 17
[3] ___ Government [6] ___ Private individual(s) [9] ___ Other ____________

8b. For your most **recent** business loan, please indicate the approximate:
1. Loan size $____________,000.00 (closest thousand) 18-20
2. Maturity (pay back period) ________ months OR ________ years [illegible]
3. Interest rate ________% OR Prime +________ [illegible]

4. Was business collateral required? (Check the **best** answer)
[1] ___ No [3] ___ Yes, Inventory [5] ___ Yes, Business real estate
[2] ___ Yes, Accounts Receivable [4] ___ Yes, Plant and/or equipment [6] ___ Don't Know 29

5. Was personal (non-business related) collateral required? (Check the **best** answer)
[1] ___ No [3] ___ Yes, Stocks, C.D.'s, etc. [5] ___ Yes, Other
[2] ___ Yes, the House [4] ___ Yes, Personal guarantee [6] ___ Don't Know 30

6. Were compensating balances required (must keep a minimum in checking or savings accounts)?
[1] ___ Yes [2] ___ No [3] ___ Don't Know 31

7. Were there any direct fees or other charges other than interest (do **not** include "points" added to the interest rate)?
[1] ___ Yes, paid up-front [3] ___ No
[2] ___ Yes, paid periodically [4] ___ Don't Know 32

7a. If "Yes," how much was the fee or charge? $________,000.00 (closest thousand) 33-34

8. Was the loan from a pre-approved "line-of-credit"?
[1] ___ Yes [2] ___ No [3] ___ Don't Know 35

9. What was the method of repayment?
[1] ___ Regular Installments [3] ___ Interest Only with Balloon Payment at the End
[2] ___ One Lump Sum [4] ___ Don't Know 36

8c. What was the purpose of this loan? (If more than one purpose, please rank them in order of importance with one (1) the most important, two (2) the second most important, etc.)
[1] ___ Maintenance and/or replacement of machinery and equipment 37
[2] ___ Expansion of physical plant (including machinery and equipment) 38
[3] ___ Inventory 39
[4] ___ Payment of taxes 40
[5] ___ Loan refinancing 41
[6] ___ Improvements made to facilities 42
[7] ___ Acquisition of real property (commercial mortgage) 43
[8] ___ Payroll or other immediate operating expenses 44
[9] ___ Start new business activity 45
[10] ___ Move to new location 46

8d. Did the loan represent the **entire amount** you originally asked for?
[1] ___ Yes [2] ___ No 47

8d1. If "No" approximately what percent of the original request did the loan represent?
[1] ___ Under 10% [3] ___ 25 - 49% [5] ___ 65 - 89%
[2] ___ 10 - 24% [4] ___ 50 - 64% [6] ___ 90 - 99% 48

8e. Did the loan have the terms you **originally** asked for?
[1] ___ Yes [2] ___ No, had to negotiate [3] ___ No discussion, terms given me 49

8f. Were the size, terms, and loan transaction generally satisfactory?
[1] ___ Very satisfactory [3] ___ Could have been better
[2] ___ Satisfactory [4] ___ Unsatisfactory 50

8f1. If everything was not satisfactory, what parts of the loan or loan transaction were not satisfactory? (Check all that apply)
[1] ___ Interest rate [5] ___ Compensating balances, Fees, Charges
[2] ___ Amount of loan [6] ___ The way you were treated
[3] ___ Maturity (pay back period) [7] ___ Transaction took too long 51-59
[4] ___ Collateral requirements [8] ___ Didn't understand your business and its needs
[9] ___ Other ____________________

9. When was the last time you tried to get a **bank** loan for your business (month and year please.)

Month

[1] ___ Jan [5] ___ May [9] ___ Sep
[2] ___ Feb [6] ___ Jun [10] ___ Oct
[3] ___ Mar [7] ___ Jul [11] ___ Nov
[4] ___ Apr [8] ___ Aug [12] ___ Dec 60-61

Year

[1] ___ 1984 [5] ___ 1980
[2] ___ 1983 [6] ___ 1979
[3] ___ 1982 [7] ___ 1978 62
[4] ___ 1981 [8] ___ 1977 or before

OR ___ Too long ago to remember

9a. Was this attempt made at your **principal** bank?
[1] ___ Yes, main location [2] ___ Yes, branch location [3] ___ Only use one bank [4] ___ No 63

9b. Was the loan approved?
[1] ___ Yes [2] ___ No [3] ___ No final decision reached 64

9c. If "No," what was the **primary** reason given for the turn down?
[1] ___ Too new a business [6] ___ Insufficient equity
[2] ___ Too much outstanding debt [7] ___ Poor repayment history
[3] ___ Lender had no money [8] ___ Weak financial statement 65
[4] ___ Use of money not considered wise [9] ___ No reason given
[5] ___ Couldn't repay loan

10. About how many times a year does your firm normally borrow? _____ times a year 66-67

11. How many **different** loan sources (**different** banks, S&L's, individuals, etc.) has your firm used in the last 5 years? _____ sources 68

12. Have the **current interest rates** caused you to cancel, postpone, or scale-down plans to expand, modernize, or renovate your business? (Check one only)
[1] ___ Yes, caused me to cancel plans [4] ___ No effect
[2] ___ Yes, caused me to postpone plans [5] ___ Undecided 69
[3] ___ Yes, caused me to scale-down plans

13. Has the inability to get all the business credit you wanted caused you to cancel, postpone, or scale-down plans to expand, modernize, or renovate your business? (Check one only)
[1] ___ Yes, caused me to cancel plans [4] ___ No effect
[2] ___ Yes, caused me to postpone plans [5] ___ Undecided 70
[3] ___ Yes, caused me to scale-down plans

14. Within the past **five** years, has a bank ever actively tried to get your firm's banking business?
[1] ___ Yes [2] ___ No 71

15. Have you noticed any change in competition for your firm's business among **banks** now compared to 5 years ago?
[1] ___ Much more competition [4] ___ Slightly less competition
[2] ___ Slightly more competition [5] ___ Much less competition 72
[3] ___ No change [6] ___ No opinion or not applicable

16. Have financial institutions **other than banks** solicited your firm's business in the last 5 years?
[1] ___ Yes [2] ___ No [3] ___ Don't Know 73

17. Below are listed a number of bank characteristics. How important is **each one** to you in conducting your firm's banking business?

	very important 1	important 2	not very important 3	not important 4	
a. Knows you and your business	___	___	___	___	74
b. Provides helpful business suggestions	___	___	___	___	75
c. Offers the "cheapest money" available	___	___	___	___	76
d. One person always handles your credit needs	___	___	___	___	77
e. Convenient location	___	___	___	___	78
f. Reliable source of credit	___	___	___	___	79
g. Knows your industry	___	___	___	___	80
h. Comes to you with ideas for improving bank service to your firm	___	___	___	___	81
i. Easy access to loan officer	___	___	___	___	82
j. Offers a wide range of banking services	___	___	___	___	83

18. How would you rate your **major** bank on these same characteristics?

	good 1	better than average 2	below average 3	not good 4	
a. Knows you and your business	___	___	___	___	84
b. Provides helpful business suggestions	___	___	___	___	85
c. Offers the "cheapest money" available	___	___	___	___	86
d. One person always handles your credit needs	___	___	___	___	87
e. Convenient location	___	___	___	___	88
f. Reliable source of credit	___	___	___	___	89
g. Knows your industry	___	___	___	___	90
h. Comes to you with ideas for improving bank service to your firm	___	___	___	___	91
i. Easy access to loan officer	___	___	___	___	92
j. Offers a wide range of banking services	___	___	___	___	93

19. About how many different banks serve your community? _____ banks 94-95

20. How many banks does your firm generally do business with? _____ banks 96

21. How large is your **principal** bank? (If you use a branch of a bank think of the entire bank.)
[1] ___ less than $100 million in assets [4] ___ Don't know
[2] ___ $100 - $499 million in assets
[3] ___ $500 million or more in assets 97

(If you don't know would you please list the name of your bank. The size will be looked up and the proper box checked for you. We want to evaluate bank performance by bank size.)

____
name of bank

22. Do you do your **personal** banking at your **firm's principal** bank?
[1] ___ Yes [2] ___ No 98

23. What is the **approximate** amount of your firm's total debt e.g. payables, mortgages, etc., expressed **as a percent** of total assets?
[1] ___ No debt [4] ___ 20 - 29% [7] ___ 50 - 59% [10] ___ Don't Know
[2] ___ Under 10% [5] ___ 30 - 39% [8] ___ 60 - 69% 99
[3] ___ 10 - 19% [6] ___ 40 - 49% [9] ___ 70% or more

24. Where is your firm located?
[1] ___ Rural area or small town (up to 15,000 population)
[2] ___ Small city (15,000 - 100,000 pop.) 100
[3] ___ City (100,000 - 1,000,000 pop.)
[4] ___ Metropolis (over 1,000,000 pop.)

24a. If "City" or "Metropolis," where is your firm located in the central city or suburb?
[1] ___ Central City [2] ___ Suburb 101

bers are in that business today. Associates Capital, CIT. They are big middle market lenders. They provide business to small business or rather credit to small businesses.

Senator HEINZ. Mr. Motley says that two-thirds of consumer banks don't promise such credit. Is he wrong on that question?

Mr. EVANS. He said two-thirds, one-third, yes.

Senator HEINZ. Is he wrong on that?

Mr. EVANS. I have no idea. I would accept those figures. My point would be, Senator Heinz that, let's suppose we didn't have consumer banks. Let's suppose that we just went ahead and reformed the system and allowed anyone to own a full-fledged commercial bank. Why don't we do that and do away with this dichotomy, which doesn't seem to suit everyone, and allow commercial banks and their owners to do whatever they want to and allow owners that don't have commercial banks to own commercial banks?

Senator HEINZ. Mr. Evans, consumer banks are, under current law, entitled to Federal deposit insurance, are they not?

Mr. EVANS. That is right.

Senator HEINZ. And S&L's and normal banks are regulated rather significantly, are they not?

Mr. EVANS. That is correct.

Senator HEINZ. Are you regulated?

Mr. EVANS. Yes.

Senator HEINZ. Are your consumer banks regulated to the same extent?

Mr. EVANS. Every consumer bank is regulated just as extensively, Senator Heinz, as any other bank. It is a bank. It just happens to be restricting its operations to either consumer or commercial. But the regulations, and we've made this very clear in our testimony, I believe, are coextensive with that of any other bank, any commercial bank.

Senator HEINZ. Are you held to the same standard of underwriting as as any commercial bank?

Mr. EVANS. Well, I think underwriting standards are not prescribed by the Government, so I assume that the main thing is that we maintain our capital, which we're very good at doing, and infusing new funds. But understanding standards are not—today, at least—set by the U.S. Government. Those are our own standards. Put it this way, no nonbank bank that I know of has failed, no unitary thrift has failed.

Senator HEINZ. When the auditors or regulators come in and they look over your assets and liabilities, and they are looking at the quality of your portfolio, that is, in effect, the application of a standard of underwriting?

Mr. EVANS. That is true.

Senator HEINZ. And I will repeat the question, are you held to the same standards as commercial banks?

Mr. EVANS. We are examined exactly—yes, we are held to the same standards and examined exactly on the same basis as any other bank, and I think you will find, if you pursue this further, that the findings have been quite favorable, that these banks have been operated quite well.

Senator HEINZ. What do you say to the argument that the rise of the consumer bank has been very tough on some commercial banks, but especially on savings and loan associations; and the Federal Government has had to engage in some extraordinary practices, in order to rescue the S&L's beyond what would have occurred if there had not been this invasion of the so-called nonbank bank loophole?

CONSUMER BANKS ACQUIRING S&L'S AND THRIFTS

Mr. EVANS. Well, I hope that is somebody else's view and not yours, Senator Heinz, because it is 180 degrees wrong, out of tune with reality. Simply, what has happened is that first, Nationwide, for instance, has been permitted to acquire a number of failing thrifts which otherwise would still be on the books of the FSLIC. The same is true of Household International, which has acquired thrifts in six or seven States which had been failing, and were losing about $60 million a year in the aggregate, which are now, with new capital put into them, are now making a profit. I think that has helped the FSLIC, not hurt them.

Senator HEINZ. Let me ask Mr. Heuer if he agrees that the advent of nonbank banks has helped the financial position of savings institutions, that is, the S&L's.

Mr. HEUER. Well, Senator Heinz, I wouldn't suggest that it has helped, but, you know, the question that you posed that Mr. Motley's testimony raised about the availability of funds to loan to small business—and I can speak with some knowledge on this, in that the bank I work for is one of the largest, most active small business lenders in the country. My concern about having funds to lend to the small business market, you know, emanates more from our concern about not being able to compete with securities firms, mutual funds, money market funds, insurance annuities and the like. If we are not permitted to compete for those funds, we are not going to have them to continue lending in the small business market.

So the opening up the competition will enable us to be more active and provide more funding in the small business market. So I think that this issue of competition for deposits is being distorted.

Senator HEINZ. I may have misunderstood you. My time is expired, so I will make this brief. Are you saying that your inability either to deal in or underwrite mutual funds would if you were allowed to do so, somehow increase what you might make in the way of commercial loans?

Mr. HEUER. In a macro sense, I think everyone will agree that the consumers in our society are net providers of funds, and what commercial banks do on is raise money in the consumer markets and lend it into the commercial market. And as we are being restricted from competing effectively in the raising of those consumer deposits by regulation, our ability to continue lending into the business market is being constrained. And I am more concerned about that than the nonbank bank, which is very small in the totality of it.

Senator HEINZ. Well, my time's expired, but I may have some questions to submit to you in writing. Thank you.

The CHAIRMAN. Well, thank you, gentlemen. This has been a very good panel with excellent give and take and both sides well-represented.

Our final panel consists of Mr. Robert Gerard, chairman of the municipal committee of the Securities Industry Association, Mr. David Silver, president, Investment Company Institute, Washington, DC, Mr. William V. Irons, who has been introduced by Senator Chafee, chairman of the National Association of Life Underwriters Financial Institutions task force and Mr. Gary Hughes, chief counsel of the American Council of Life Insurance.

Good morning, gentlemen, we are very happy to have you here.

Mr. Gerard, go right ahead, sir.

STATEMENT OF ROBERT A. GERARD, MANAGING DIRECTOR, MORGAN-STANLEY, INC., CHAIRMAN, MUNICIPAL COMMITTEE, SECURITIES INDUSTRY ASSOCIATION

Mr. GERARD. Thank you, Mr. Chairman, it is a pleasure to be here. I am Robert Gerard. I am managing director of Morgan-Stanley, Inc. in New York and chairman of the Securities Industry Association [SIA] municipal finance committee.

We have submitted an extensive statement for the record, and I will keep my oral remarks as brief as possible today.

The CHAIRMAN. Thank you, sir.

Mr. GERARD. The position of the SIA is in opposition to the proposal to grant bank holding companies new powers to deal in commercial paper, municipal revenue bonds and mortgage-backed securities.

Many members of this committee, Mr. Chairman, including yourself have expressed the belief and support for the principle that commercial and investment banking ought to be kept separate, a principle which, as we all know, is the cornerstone of Glass-Steagall.

We believe the members of this committee when they say that, but with all due respect, it's hard for me to see how a belief in Glass-Steagall is consistent with granting these powers to banks but allowing them to retain all their competitive advantages derived from the bank charters.

BANKS SEEKING REPEAL OF GLASS-STEAGALL ACT

What is really being sought here today by the large banks in this country is repeal of Glass-Steagall for themselves alone. The powers that the banks are seeking here today would allow them to underwrite and trade in virtually everything which the Glass-Steagall Act prohibits, except all corporate debt and equities. This is no small change in Glass-Steagall alone, but in the District of Columbia, in my State of New York and in Delaware, at the same time they are seeking for these so-called limited powers here, they are seeking full power to underwrite corporate securities. If they succeed at the State level, as we've seen with respect to their, hopefully, temporary successes at the regulatory level, they will be back here again, sooner rather than later, asking for your blessings for such back door repeal of Glass-Steagall.

We believe that Glass-Steagall has been a beneficial force and continues to have relevanace today; however, we recognize that 50 years, the time that Glass-Steagall has been in force, is a long time, and for 10 years SIA has called upon this committee to do a thorough, academic review of the Glass-Steagall Act and the other banking and securities laws that govern the relationship between commercial and investment banks.

Recently, we've seen statements by groups dominated by the major banks calling for the same, and that's fine, but the difference in our position is that while Congress is considering these matters, the banks want new loopholes and new powers, effectively repealing most of Glass-Steagall in advance.

The Federal Reserve, which has, in recent months, become a participant, an active participant in this process, and the States, should be told not to usurp the prerogatives of Congress and foreclose your options. Once a loophole has been opened by regulatory fiat, as this committee has painfully learned with the nonbank bank question, it is extremely difficult for Congress to change. And there can be really no question that what's being urged upon the Congress here is repeal of Glass-Steagall. It is a major attack on the letter and spirit of the law. Commercial paper is a corporate security, pure and simple. Private mortgage-backed securities are traded in the marketplace like corporate debt, and revenue bonds are largely not supported by the taxing power of governments and are, as we well know, prime subject for bank tying arrangements.

Now there are a number of approaches that have been put forward by many segments of the industry to satisfy the desire of financial institutions to be "all things to all people." Financial services holding companies, other structures, all designed to get banks into securities underwriting. All of these proposals raise issues. Now we have a position on those issues. We think that most of the proposals don't make sense, but we're not prepared to live or die solely on the basis of our assertions.

What we would like to see is Congress consider the whole host of questions that really relate to those issues. Do we really want to trade the diversified financial system we have now for a concentrated system, in which a few mega institutions control all the financing power in this country? Do banks really need securities powers to remain profitable? Are banks really unprofitable today? Many have asserted such, but when you look at the Fed studies of major banks in this country away from the money center banks, they look like they've been more profitable than any time since the Second World War.

Is the system, as it exists domestically, competitive and are banks really uncompetitive, internationally?

These are only a few of the many questions that we feel ought to be addressed in detail before any change is made in Glass-Steagall.

I see the red light is on, Mr. Chairman. I'll be glad to expand upon my views in response to your questions.

[The complete prepared statements of Robert A. Gerard and John W. Bachmann follow:]

ORAL STATEMENT OF ROBERT A. GERARD
on behalf of
SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

JANUARY 23, 1987

I am Robert A. Gerard, head of the Municipal Finance Department of Morgan Stanley & Company and Chairman of the Securities Industry Association's Municipal Finance Committee. SIA represents more than 500 securities firms (including some banks) located throughout the United States and Canada. John W. Bachmann, Managing Partner, Edward D. Jones & Co., and Chairman of SIA was scheduled to testify but could not change a long-standing commitment when the Committee changed the agreed date of testimony from January 22nd to January 23rd.

We appear today in response to your invitation to provide our views on whether Congress should grant bank holding companies new powers to deal in commercial paper, municipal revenue bonds, and mortgage backed securities. We oppose the grant of such securities powers to banking organizations.

We have detailed our objections in a lengthy written statement that we have filed with the Committee. We firmly believe that what is being proposed strikes at the heart of Glass-Steagall and is not in the best interests of this country, of the capital markets or, ultimately, the banking industry.

Chairman Proxmire, you have been quoted recently as expressing your belief in and support for the principle that commercial and investment banking should be kept separate, a principle which is the cornerstone of Glass-Steagall. We believe you when you say that, but with all due respect, Sir, you cannot understand the scope of our business you propose to open to banks in competition with our members, while the banks retain all their competitive advantages derived from their bank charters, and still believe in Glass-Steagall.

What is being sought by the large banks of this country is really the repeal of Glass-Steagall for banks. Banks are seeking power at this time to underwrite virtually everything which the Glass-Steagall Act prohibits except all corporate debt and equities. This is no small change. In D.C., New

York and Delaware they are seeking full corporate powers as well. No doubt they will be looking for the same here in short order.

In this one-way clamor for new securities powers for banks, we cannot forget that this has been since the 1930's, and remains, a very complex matter. Safety and soundness of banks, unfair advantages for banks, conflicts and concentration of economic power are just some of the issues involved. Congress split commercial banking and investment banking apart with the lessons of history fresh in mind.

We believe that Glass-Steagall has been a beneficial force and continues to have relevance today. However, we recognize that 50 years is a long time. SIA has for ten years called upon this Committee for a complete review of the Glass-Steagall Act and the other banking and securities laws governing the relationship of commmercial banks and investment banks. We repeat that call today.

While Congress is considering these matters new loopholes in the Glass-Steagall Act should not be opened. The Federal Reserve Board should be told not to usurp the prerogatives of Congress and foreclose congressional options. Once a loophole is opened by regulatory fiat it becomes increasingly difficult for Congress to close it. The nonbank bank loophole is a prime example.

What is being urged upon Congress is truly momentous. It constitutes a major attack upon the letter and spirit of Glass-Steagall. Commercial paper is a corporate security. Private mortgage-backed securities are like corporate debt. Revenue bonds are not government supported either and are prime subjects for bank tying arrangements.

There are a number of approaches being put forward to satisfy the desires of a small number of financial institutions to be "all things to all people." New financial services holding companies are being proposed as are other structures designed to get banks into securities underwriting. These proposals as does your proposal to grant new securities powers to banks raise a host of issues which have not been examined and must be examined before any major changes in Glass-Steagall can be considered: Let me mention a few:

- o Can we imagine a better result from any other set-up than Glass-Steagall has given us: a sound banking system, capital markets second to none and financial power spread across two separate industries?

- o Do we really want to trade a diverse and varied financial system for a universal banking system with the economic power concentrated in the hands of a few?

- How do we ensure that allowing banks into new fields will be pro-competitive and not just a step on the road to greater concentration of financial power? Will banks be allowed to buy securities firms?

- What benefit will there be for U.S. capital markets from bank entry into these underwriting activities? There has been no demonstration of benefit, only assertions by banks.

- Banks claim they need new securities powers to remain profitable. Are banks really unprofitable? Recent evidence suggests that they are not. Most large banks had their most profitable year in recent history in 1986.

- Are U.S. banks really uncompetitive internationally? U.S. banks rate high in the world in terms of profitability. Asset growth of Japanese banks is largely a result of the increased value of the yen. Japan has its own Glass-Steagall yet its banks are doing well. Should change in Glass-Steagall be coordinated with changes in Japan's Article 65?

- What advantages are there for the public, the consumer and business in these proposed changes?

- Why cannot banks meet consumer needs under the current banking system? What would it be like if banks get diverted into other activities?

- Banks have special government-conferred benefits to provide banking services. How do we ensure that banks do not neglect their public trust in favor of non-banking activities?

- How do we initially capitalize securities affiliates for the notoriously capital-intensive securities underwriting business when banks are themselves capital-short? How do we isolate banking capital so that it will be available for fulfilling the basic bank mission?

- How do we provide continuing capital for the new securities affiliate, since clearly it would be unfair for it to obtain capital by loan or investment from an affiliated bank? Will the problems presented by "double-leveraging" by holding companies be compounded with the addition of a securities affiliate?

- How can the rest of us be protected against the unfair tying arrangements that banks constantly deal in but are rarely caught at? The situation will be worse the more activities outside of banking they can enter.

- Can the cost-of-money and other government-conferred advantages that banks have be neutralized in activities outside of banking?

- How do we ensure that other financial institutions will not be subjected to unfair bank competition? Should these other institutions be given the benefit of federal deposit insurance and access to the Federal Reserve discount window? What role should nonbank banks play?

- What kind of problems will these new ventures create for the banking system as a whole? Will banking organizations be bailed out by bank regulators if they get into trouble in their new securities activities? Is that fair for organizations that do not have that support? Is that right for the American taxpayer? Will it be possible to shield banks, the insured deposits of investors, the U.S. Treasury and the taxpayers from the cyclicality and volatility of the securities business? With the federal deposit insurance system having its greatest number of failures since the Great Depression, is this the time to be adding new risks?

- How complicated will the new regulatory arrangement have to be to take care of this much more complicated set of structures? What will fall through the cracks? Will such a complicated arrangement be workable?

- How will conflicts of interest be avoided? Will simple disclosure work? Will secrecy about internal bank problems continue to be the order of the day?

- Are securities affiliates to be prohibited from securities buy-and-sell transactions with affiliated banks and their trust and pension accounts?

- Should all Glass-Steagall loopholes be plugged so as to bring all financial institutions under the same rules, including state-chartered insured banks and thrifts?

- Are the real problems within the banking system problems of management? Why is it that so many well-run banks are doing well if there are structural problems?

These are only some of the questions that need to be asked and answered before major changes in Glass-Steagall should be considered.

It is possible that the only fair thing is total repeal of Glass-Steagall. Securities firms then could operate fully in the banking business. Total repeal at least would be a two-way solution and not the one-sided repeal being sought by the banks. SIA does not believe that full or partial repeal of Glass-Steagall is the right answer, but full repeal looks better than the partial repeal that is being proposed.

Glass-Steagall has brought us a financial marketplace of unequalled depth, diversity and strength. In fact, Glass-Steagall has been so successful, it is hard to believe than anyone is seriously proposing that it be changed. A fair and impartial review may well lead to a strengthed and reinforced Glass-Steagall.

We hope Congress will ignore the misleading scare stories and myths being circulated to prod Congress to act in haste. The sky is not falling. Internationalization and securitization do not foretell the end of the world. Good banks are continuing to make good money in banking. Securities underwriting is not the answer for energy and agricultural loans. No crisis is forcing Congress to act before it has given these matters adequate consideration.

A comprehensive Congressional examination could shape our financial markets for decades to come. The review should be done expeditiously but carefully. Our industry will cooperate in that effort. We want Congress, if it concludes that changes are called for, to fashion laws that will ensure a sounder banking system, the continuation of the best capital markets in the world and an environment that will be fair to all. What is being proposed does not meet that test.

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STATEMENT OF SECURITIES INDUSTRY ASSOCIATION

PRESENTED BY JOHN W. BACHMANN

BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

JANUARY 23, 1987

I am John W. Bachmann, Managing Partner, Edward D. Jones & Co., and Chairman of the Securities Industry Association ("SIA"), an association of more than 500 securities firms (including some banks) located throughout the United States and Canada. My firm, Edward D. Jones & Co., a partnership, is headquartered in St. Louis, Missouri and we do business through 1040 offices in 36 states. With me today is Robert A. Gerard, head of the Municipal Finance Department of Morgan Stanley & Company and Chairman of SIA's Municipal Finance Committee.

I. Introduction

We appear today in response to your invitation to provide our views on whether Congress should grant bank holding companies new powers to deal in commercial paper, municipal revenue bonds, and mortgage backed securities. We oppose any weakening of the Glass-Steagall Act that would result from granting banks these powers. Instead, we urge Congress to begin a total review of the Glass-Steagall Act and related laws regulating the providers of financial services.

SIA has been and remains a strong supporter of the Glass-Steagall Act's separation of commercial banking and investment banking. As early as 1864, with the passage of the National Bank Act, Congress mandated the separation of commercial banking from commerce. Except for the disastrous years of experiment brought on by enactment of the McFadden Act in 1927 and ended by the Glass-Steagall Act in 1933, Congress has maintained that separation principle and enhanced and reinforced it in the Bank Holding Company Act of 1956, and as amended.

Although there has been a virtually continuous demand initiated and orchestrated by a few large financial center banks, supported by their friendly bank regulators, to amend or even repeal the law, the case for retaining Glass-Steagall remains as strong today as in the past. In fact, we today urge Congress to act immediately to close the loophole in the law which the country's largest banks are seeking to exploit in a manner that contravenes the obvious and fundamental intent of Congress in passing the law. This loophole is the subject of a hearing before the Federal Reserve Board on February 3.

The arguments for maintaining the separation of commercial and investment banking center are the need to avoid conflicts of interest and unfair bank competition, the need for depositor confidence in the banking system, the safety of the depository insurance funds and the prevention of undue concentration of economic power.

Despite the oft and sometimes shrill arguments of those who would amend or repeal Glass-Steagall that U.S. banks are falling behind their competition worldwide (a very questionable assertion), there is little evidence to support a finding that banks cannot earn an adequate return in banking. The success of the domestic banking industry, collectively and separately, is far more dependent upon sound management and the impact of economic forces such as the downturn in energy prices and agricultural oversupply than on Glass-Steagall. Indeed, despite such problems our nation's large banks (except for the nine money center banks which had troubles in their international operations) had in 1985 the highest return on equity that they have had since before 1970.

Despite our firm support of Glass-Steagall and the belief that the law should be maintained and even strengthened, we recognize the need for a responsible Congress to review the statutory and regulatory scheme which governs our financial system and to determine whether that scheme is adequately responsive to a rapidly changing world. We have consistently urged such a review in prior appearances before this Committee. This is an essential prerequisite to consideration of any changes in Glass-Steagall of the magnitude suggested. Before we start down a road which will inevitably lead to a concentration of financial resources, we should have a clear idea of what will be gained and what will be lost. Congress should not cede this responsibility by inaction to bank regulators who too often are most responsive to the wishes of the institutions they regulate.

We offer a word of caution to anyone predisposed to amend or repeal Glass-Steagall. The issues posed by reducing or eliminating the barriers separating commercial and investment banking are far more complex than they may appear at first glance. Requiring all securities activities of a bank holding company to be conducted in a separate bank affiliate has been proposed as the proper approach if banking and securities activities are to be conducted as parts of a commonly owned and controlled enterprise.

While the separate affiliate concept is far preferable to permitting securities activities to be conducted in a bank or bank subsidiary, the construct of the relationship between the securities affiliate and other parts of the holding company must be carefully formed if the problems the Glass-Steagall separation principle prevents are to be avoided. Nonetheless, the probability remains that even with the best statutory separate affiliate concept in place, the risks to the depository insurance funds and the U.S. Treasury will be far greater than prevails now under Glass-Steagall.

We do not confront a crisis situation that compels the Congress to grant banks additional securities powers at this time. The essential first step for Congress in considering these matters is to undertake a comprehensive review of our laws which regulate banking and securities activities. Such a review should include the participation of the Securities & Exchange Commission, the bank regulatory agencies, the appropriate representatives of the executive branch, consumer groups and the best available talent in the financial and academic communities. Only through such a process will intelligent and wise legislative judgments emerge.

II. The Issue of Bank Securities Powers: Past and Present

The present controversy over the extent to which banks should be in the securities business finds origins in the development of our federal and state bank regulatory policies beginning in the mid-nineteenth century. The separation of commercial banking from other areas of commerce became a cornerstone of bank regulatory policy with the enactment of the National Bank Act of 1864. Since that time, an elaborate pattern of federal and state law has developed, preserving certain fields of financial activity exclusively to commercial banks and, in turn, limiting bank entry into other fields. This protection and circumscription was meant to bolster the growth of a strong, but properly focused, banking system.

To facilitate and safeguard their special role as the custodians of the bulk of the liquid savings in the economy and the primary suppliers of the nation's short and medium term credit requirements, banks were made the beneficiaries of a legislated support apparatus which came to include access to the discount window at the Federal Reserve, deposit insurance and protection from competition by laws limiting freedom of entry into the business of banking. Although these benefits have to some extent offsetting costs, such as reserve requirements and insurance premiums, on balance they provide banks significant advantages in the competition for the public's funds. Our banking history, however, is marked by the relentless struggle of a handful of the largest financial center commercial banks seeking to exploit their statutorily derived advantages in activities of a financial and commercial nature in competition with those who do not enjoy similar advantages.

Beginning in the early 1920's, the large commercial banks developed a strong interest in the securities business. Since they were barred by statute or charter from conducting a securities business in the bank, they created affiliates.[1]

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[1] The device consisted of the organization of state-chartered institutions, owned and controlled pro rata by the stockholders of national banks. Affiliates were chartered with general powers so that they might be in a position to handle any financial transactions that seemed profitable. The names of the affiliates resembled very closely the names of their parent banks, and the similarity of names was designed to give the impression to the customers of both that the two were closely allied. It was customary to have the main offices of the banks and their affiliates in the same building. Immediately upon their organization, affiliates enjoyed the full benefit of the goodwill of their parent bank and of advertising by the banks. For example a parent bank, after the organization of its affiliate, might advertise that it was then in a position to offer its customers investment banking facilities through its affiliate. The close relationship between the banks and their affiliates is further revealed by the fact that the profits of affiliates were distributed ratably among the stockholders of the banks, and the business that the affiliates were ostensibly organized to conduct was to consist mainly in providing customers of the banks with financial facilities not permitted under the national banking laws. Peach, Security Affiliates of National Banks (1939), The John Hopkins Press, p.52 (hereinafter cited as "Peach").

The doubtful legal authority of such affiliates to engage in securities activities operated to restrain their growth. The legal doubts were removed by the passage of the McFadden Act in 1927.

The effect of the enactment of the McFadden Act was dramatic. In the four year period from 1927 through 1930, the originations of new issues by banks increased from 22% of total originations in 1927 to 44.6% in 1930. The share of investment bankers decreased correspondingly from 78% of total originations in 1927 to 55.4% in 1930. Similarly, the banks and allied institutions increased their share in participations from 36.8% in 1927 to 61.2% in 1930, while that of investment bankers decreased correspondingly from 63.2% in 1927 to 38.8% in 1930.

The extent of the role of banks in the securities business as a contributing factor in the collapse of the banking system and the ensuing Great Depression of the 1930's has become the subject of debate by revisionists of the economic history of that era, most of whom work for banks. What is beyond dispute, however, is that your predecessors serving in Congress at the time, following extensive and comprehensive hearings, concluded there was a substantial cause and effect relationship between bank involvement in the securities business and the collapse of the banking system. The result was the enactment of the Glass-Steagall Act, separating commercial and investment banking, as part of the National Banking Act of 1933. The separation doctrine was enhanced and strengthened by the enactment of the Bank Holding Company Act in 1956. The Senate Committee Report on that legislation stated:

> In general, the philosophy of this bill is that bank holding companies ought to confine their activities to the management and control of banks and that such activities should be conducted in a manner consistent with the public interest. Your committee believes that bank holding companies ought not to manage or control non-banking assets having no close relationship to banking.[1]

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[1] S. Rep. No. 1095, 84th Cong., 1st Sess. pp. 1-2 (1955).

The vast majority of banks have been content to operate under the separation principle, but the major financial center banks have consistently chafed under the restrictions imposed on their activities by Glass-Steagall and the Bank Holding Company Act. Within two years following its enactment, an effort was made to repeal Glass-Steagall. Beginning in the 1950's these large banks commenced efforts to amend the Act so that they could underwrite municipal revenue bonds. Then, and for many subsequent years, the banks said they did not seek repeal of Glass-Steagall, but only wanted revenue bond underwriting authority. The first congressional hearings on legislation to allow banks to underwrite revenue bonds occurred in the House in 1963, and were followed by numerous subsequent hearings on the same subject. Beginning in 1981, however, the legislative goals of the banks broadened and bills were introduced (on which hearings were held by this Committee) that would have allowed securities affiliates of commercial banks to underwrite and deal in all revenue bonds, commercial paper, mortgage backed securities and mutual funds. A chronology of hearings related to Glass-Steagall issues during which SIA or its predecessors appeared to testify is attached as Appendix A.

The arguments banks have made for increased securities powers have varied over the years. When what they sought were powers to underwrite and deal in ineligible municipal revenue bonds, their argument was based almost solely on presumed net interest cost savings which issuers would realize from increased competition. That argument was totally discredited in extensive hearings in 1979 conducted by the House Subcommittee on Financial Institutions and is rarely advanced today.

Early in the 1980's, when interest rates on deposits were still controlled, the banks argued that money market mutual funds offered by securities firms were eroding their deposit base and the remedy sought to cure the ill was, again, increased securities powers. Congress wisely responded with the Garn-St Germain legislation deregulating interest rate controls, and some $300 billion quickly flowed into bank money market accounts. Banks nonetheless continued to press for broad securities powers.

Now banks say expanded securities powers are required to compensate for diminishing short and intermediate loan portfolios allegedly caused by Glass-Steagall restrictions on their activities. The same argument, the decline in bank commercial loan portfolios that occurred in the 1920's, was advanced by banks then as a principal reason for their need to engage in the securities business.[1]

The desire of banks to break down or eliminate the barriers separating commercial and investment banking has been pursued not only in the Congress and state legislatures, but also before friendly bank regulators in numerous administrative proceedings. SIA and others have opposed the banks in many of these proceedings, and we frequently have sought judicial review when we thought the results were wrong and contrary to the intent of Congress in enacting the relevant statutes. We have won some and we have lost some. A summary of these proceedings is attached as Appendix B.

We hear banks talk about using their new powers to benefit the consumer of banking services. But whenever this committee has canvassed consumer groups to determine whether they want the Glass-Steagall wall breached, they have responded uniformly with calls for caution.

III. Banks Enjoy Unfair Competitive Advantages, Many of Them Government-Conferred

1. Federal Insurance and Access to the Fed's Discount Window

Financial intermediation by banks involves the accumulation of savings as deposits and the lending of these funds to those with capital needs. Banks enjoy federal subsidies of the two basic costs elements in intermediation -- a rate of return sufficient to induce holders of excess funds to deposit them, as well as the cost of the intermediation process itself -- so that those who need funds may obtain them relatively inexpensively.

Federal deposit insurance serves to lower the rates of return required to attract depositors. Deposit insurance makes bank deposits up to prescribed levels virtually "risk free." Depositors in any federally-insured institution are guaranteed absolutely against losses up to $100,000, a guaranty backed ultimately by congressional appropriation power. Moreover, as the Continental Illinois debacle graphically illustrated, the Federal government will not permit a major bank to fail. Because of the catastrophic consequences such a failure would have on the entire financial system, holders of nominally "uninsured" deposits in these institutions are effectively fully guaranteed by virtue of the "too big to fail" phenomenon. Federal insurance -- specified to $100,000 and implied at least for large banks beyond that amount -- constitutes a specific cost-savings advantage that banks alone enjoy.

In addition, banks have ready access to short-term capital at low cost through the federal funds market and the Fed's discount window. The cost to banks of long-term capital also is lower because of reduced risks associated with investment in the banking business. Such reductions in risk result in part from the readiness of the Fed to provide low-cost credit through the discount window to meet banks' temporary liquidity problems.

Economists would classify these special advantages and privileges -- deposit insurance and access to the discount window and the federal funds markets -- as "subsidies," the purpose of which is to lower the cost of funds. These subsidies are paid for directly or indirectly by the public.

Subsidies are provided to banks in the expectation that the savings will be passed on to borrowers of funds, thereby reducing borrowing costs, making credit more freely available and stimulating economic growth. Allowing these subsidies to fund securities or other non-banking activities of banks constitutes an unfair competitive advantage for banks.

Banks can and do extend credit to their affiliates in amounts and on terms that other firms could never secure. To reassure the Congress and regulators that non-bank affiliates would not enjoy an unfair advantage, bankers frequently cite Section 23A of the Federal Reserve Act, which generally is intended to require adequate collateralization of loans by member banks to their affiliates. But Section 23A, which was "liberalized" by the "Banking Affiliates Act of 1982, is hardly even a mild restraint on bank loans to affiliates.

2. Permissive Regulatory Structure

In addition to inherent cost advantages, an additional competitive advantage banks have is their position under the securities laws. Bankers frequently claim that the body of securities regulation developed over the past 50 years justifies the elimination of Glass-Steagall. What this contention conveniently fails to acknowledge is that banks have enjoyed broad exemption from a major portion of these securities laws and regulations -- and are unwilling to see this exemption diminished in any way.

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[1] Peach, chap. II.

This became evident in late 1983 when the SEC, prompted by the spread of bank brokerage activity and "investor protection and other regulatory concerns raised by the recent expansion of bank securities activities," adopted a rule that required banks performing certain securities activities to register as broker-dealers under the Securities Exchange Act of 1934 ("1934 Act"). The vigorous opposition of the major banking organizations, as demonstrated by the American Bankers Association's successful lawsuit overturning the SEC's authority to promulgate the rule, bears eloquent witness to just how important this exemption is to banks.

Section 3(a)(4) of the 1934 Act defines the term "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." (Emphasis added). This statutory exclusion was based on the congressional understanding that banks generally were prohibited from engaging in the securities business under the Glass-Steagall Act. Those who are classified as "brokers" under the 1934 Act are required to conform to a comprehensive system of governmental and self-imposed regulation developed over the years for the protection of investors. Banks offering brokerage services outside a registered broker-dealer subsidiary, however, are not subject to the standards and safeguards provided under this system. These customer protections relate to advertising, broker training, suitability, prompt and best execution, prompt delivery of securities and confirmations with regard to each transaction, disclosure of adverse information, and insurance under the Securities Investor Protection Act.

Shielded by their exemption, banks therefore enjoy a substantial regulatory advantage over securities firms, which are subject to stringent controls and operate under the watchful eye of the SEC.

Despite recommendations of a special report to Congress on the bank "broker-dealer" exemption completed by the SEC in 1977, the bank regulators have taken only the most tenuous steps to provide meaningful protection for bank securities customers. Since banks already provide over 50 percent of

discount brokerage services, this regulatory anomaly leaves a large group of consumers unprotected by the securities laws and confers an unfair advantage on banks.

3. Bank Tie-Ins

Another unique competitive advantage of banks is their ability to extend credit, the availability of which can be "tied" to use of the bank's securities services. These tie-ins, whether explicit or implicit, involve the linkage of bank credit facilities with securities services.

A bank may condition lower borrowing costs or the availability of its credit facilities altogether on an issuer's patronage of the bank's private placement or commercial paper services. For example, most commercial paper is backed by a bank credit facility. This gives banks the opportunity to tie the availability of a credit line to use of the bank as distributor of commercial paper for the issuer.[1] The same potential for tie-ins exists in the underwriting of mortgage-backed securities as well.

Whether or not such tie-ins are formal, potential borrowers may feel obligated to use various securities services offered by their bank in the belief that such patronage enhances their "creditworthiness." Particularly when short-term credit becomes a relatively scarce and valuable commodity, customers may feel obliged to be "good customers" of their bank in all respects.[1]

The dangerous potential for voluntary tie-ins occurring in such circumstances was emphasized and illustrated by Richard W. McLaren, then Assistant Attorney General in charge of the Antitrust Division, in his testimony before the Senate Committee considering bank holding company legislation in 1970:

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[1] The Federal Reserve Board has recognized the danger of this practice in the recent litigation involving Bankers Trust Company.

[1] For the results of a study of such tie-ins, see Appendix C.

> Bank expansion in other areas permits the carryover of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature -- adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere.
>
> I refer to a voluntary form of reciprocity or tie-in effect, where a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank-affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.
>
> This can be illustrated by an example. A potential loan applicant might voluntarily place his casualty insurance business with a bank-affiliated insurer in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in. Competition in the tied product, insurance, would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. One such merger might well trigger others and as a pattern of such bank-insurance affiliations developed, market foreclosure in the tied field would become more and more serious.[1]

The Conference Committee that reported the Bank Holding Company Act Amendments of 1970 echoed McLaren's concerns:

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[1] One Bank Holding Company Legislation of 1970, Hearings Before the Senate Comm. on Banking and Currency, 91st Cong. 2d Sess. 239-40 (1970). See also Mr. McLaren's remarks before the House Committee: The Bank Holding Company Act Amendments: Hearings Before the House Comm. on Banking and Currency, 91st Cong., 1st Sess. 90-92 (1969).

> Such tie-ins may result from actual coercion by a seller or from a customer's realization that he stands a better chance of securing a scarce and important commodity (such as credit) by 'volunteering' to accept other products or services rather than seeking them in the competitive marketplace. In either case, competition is adversely affected, as customers no longer purchase a product or service on its own economic merit.[2]

Moreover, as is apparent from the following passage from a major bank holding company's antitrust compliance manual for staff, it is altogether reasonable for a loan applicant to expect that bank lending officers will take into account the applicant's other relationships with the bank and its affiliates:

> Also, the tying provisions [of the Bank Holding Company Act] do not prohibit the Bank, its operating subsidiaries, or the Corporation's domestic non-bank subsidiaries, from taking into account present or past satisfactory relationships with a customer when selling or pricing a loan or other service. However, this must remain an internal consideration and cannot be conveyed to the customer in terms which imply that the customer is expected to continue the other relationships in the future.[3]

The possibility of tie-ins occurring seems all the more likely when one considers the active "cross marketing" of products in which banks engage. The heightened danger should be clear from another excerpt from the antitrust compliance manual. After cautioning bank officers against illegal mandatory tie-ins, the manual states:

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[2] H.R. Rep. No. 1747, 91st Cong., 2d Sess. 18 (1970).

[3] BankAmerica Corporation, Antitrust Compliance, p. 6 (1980) (emphasis in original).

> Bank officers can offer to customers the full range of available Bank services which may be of interest to the customers. They can also advise customers of the availability of services offered by affiliates of the Bank and can offer to put the customer in touch with the affiliate if the customer so desires.[9]

While cross marketing is not illegal, it seems apparent from the emphasis given to the practice by major banking organizations that most customers do not fail to take the hint.

Bankers are fond of calling for repeal of the Glass-Steagall Act to create a "level playing field," permitting head to head competition between banks and securities firms. But as long as banks enjoy the advantages of government granted preferential access to credit, exemption from securities regulations, and ability to tie bank services with non-bank services, talk of a level playing field is disingenuous at best.

The congressionally designed system of distinct financial intermediaries -- with different regulatory schemes -- was no accident. It was the product of reasoned thought and careful congressional debate.

IV. The Specific Securities Underwriting Powers Banks Are Asking For

1. Municipal Revenue Bonds

When the Glass-Steagall Act became law, its principal exceptions to the complete prohibition of banks from underwriting and dealing in securities were to permit them to underwrite and deal in federal, state and local general obligations. The reason for the exceptions was to ensure that these governmental units had a market for those bonds. General obligation bonds, unlike revenue bonds, were backed by taxing power, and were deemed to be as safe as any securities could be. Therefore, the governments would not have to rely on an infant separate securities industry, in effect created by the Glass-Steagall Act, to buy their general obligation notes and bonds, which were needed to fund government's way out of the Depression.

Proposals to amend federal statutory prohibitions on bank underwriting and dealing in municipal revenue bonds issued by state and local governments have been before the Congress for more than 30 years and have been the subject of comprehensive hearings before Senate and House Banking Committees on nearly ten occasions. With one exception these proposals have been rejected. The exception was a limited amendment to the 1968 Housing Act to allow banks to underwrite revenue bonds issued for college and university dormitory and housing purposes.

The "tie-in" by banks of the grant of a credit enhancement facility with a managing underwriting role in connection with the issuance of bank-eligible municipal revenue bonds is becoming increasingly prevalent. In other words, the extension of a letter of credit supporting a bond obligation is "conditioned" (the quid pro quo may not be explicit) upon the bank obtaining a managing role in the underwriting syndicate.[10]

Great potential for a "tie-in" arises when a bank is asked to extend a letter of credit to support a certain type of tax-exempt housing revenue bond issue. Those instruments, known as "option bonds" or "put bonds," normally are underwritten by a syndicate. They give holders the right to redeem their bonds at par on certain dates up to thirty years in the future, regardless of current market value. A letter of credit is provided, at a very substantial fee, to fund payments to bond holders exercising their redemption option. The large money center banks have the unique ability to condition the granting of a letter of credit on being awarded managing underwriter status, and reportedly have done so on more than a few occasions.

In the area of municipal bonds, commercial banks face an exceedingly difficult job handling the multitude of roles they concurrently perform for municipal issuers. These roles are underwriter to the municipality, depository of its funds, investor in its securities, trustee of its bond and note issues, lender to the municipality and, lastly, its financial advisor. Thus, at one time they are charged with simultaneously protecting the best interests of depositors, shareholders, trust accounts and the municipal issuers they serve.

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[9] *Id*. at 6-7.

[10] See Study at Appendix C.

The only significant argument advanced by the few large commercial banks that seek expanded underwriting powers is that their entry into the market will increase the number of bidders thereby lowering net interest costs to issuers. The subject became a battle of experts. Their studies were the subject of intense scrutiny during five days of hearings in 1979 before the House Subcommittee on Financial Institutions. The bank-sponsored study was rejected and the finding accepted that there was no evidence that an extension of bank eligibility to underwrite all revenue bonds would result in any significant savings for bond issuers.

The banks have now abandoned reliance on the discredited study and the argument that expansion of their underwriting powers in the revenue bond market would produce interest savings for issuers has been muted. The more than 500 securities firms actively engaged in underwriting and dealing in revenue bonds assure issuers the full benefits of competition.

2. Mortgage-Backed Securities

A mortgage-backed security or a mortgage-related security (MBS collectively) is a fixed-income security, much like a corporate bond. An investor in an MBS faces the same uncertainties as an investor in a corporate bond, and more. Usually the security for payment is only the underlying pool of mortgages. If the mortgages are guaranteed or insured, the assurance of ultimate payment is much better. The MBS issued by federal agencies--Ginnie Mae, Fannie Mae and Freddie Mac--are viewed by the market as having that extra assurance.

In the turbulent markets of the past few years securities representing interests in low-yielding mortgages fell to deep discounts from face value. While there is a highly organized market for corporate securities, there is much less of a one for mortgage-backed securities and they are not as liquid as corporate securities.

Banking institutions are today prohibited from underwriting mortgage-backed securities where there is no government relationship, just as in the case of corporate bonds.

Exceptions added to the Glass-Steagall Act since 1934 have routinely permitted banking organizations to underwrite and deal in obligations issued by federal agencies. In contrast to the government-sponsored MBSs, which support low and moderate-income homeowners, the emerging, new, completely private MBS market is intended to serve higher income homeowners who need large mortgage loans and where federal agency back-up and involvement is not warranted.

As a matter of federal housing policy, many believe that banks should be limited to assisting low and moderate-income homeowners through underwriting and dealing in those MBSs with federal agency support and not be diverted to the "upscale" customers.

Also, MBSs of the three federally-chartered agencies involve less risk because of their federal relationships and long history of standardization. There is no federal credit support or industry mortgage standard for the privately-sponsored MBS.

In addition, the need for supporting credit facilities as "homogenizers" and for assuring definite maturities is greater with privately-sponsored MBSs than for government agency MBSs. Therefore, the potential for banks and bank affiliates getting involved with unfair tying of bank letters of credit to the underwriting of MBSs is much greater than when federal agencies are involved.

Finally, one of the main benefits for banking and thrift organizations in selling fixed-rate mortgages is to divest themselves of the market risk of money. To allow them to underwrite and deal in privately-sponsored MBSs is to hand them back the market risk they get rid of when they sell their fixed-rate mortgages; it was the holding of these mortgages which proved so disastrous for them the past few years.

Indeed, it is questionable to what extent privately-sponsored MBSs should be eligible for bank investment at all. The recent disaster provided by Equity Programs Investment Corp. (EPIC) involved privately-insured mortgage loans which were packaged into $1.4 billion in mortgage-related securities. When banks and thrifts operate in a securities market where there is no government support or standardization, they increase their risks enormously and unnecessarily. Those risks are precisely the kinds of risk that Congress separated from banking in the Glass-Steagall Act.

There is no need for bank participation in the riskier, non-government private MBS market. By contrast, the need for banking organizations to support the mortgage market for veterans and low and moderate income homeowners is great and banks should not be diverted into riskier, upscale, private securities mortgage-related securities markets.

3. Commercial Paper

Commercial paper is a short-term (270 days or less) note of a corporate issuer. Over 50 years ago, an exemption from registration was included in the Securities Act of 1933 based upon the short-term nature of these securities. Banks first began to underwrite and distribute these notes about six years ago when Bankers Trust Company announced its entrance into the business. A lengthy regulatory and legal proceeding followed culminating in 1984 when the Supreme Court determined that these notes are securities within the meaning of the Glass-Steagall Act.[11] The question of whether bank "placement" of commercial paper in that case constituted underwriting, distributing, or selling the security in violation of the Glass-Steagall Act was decided favorably to the banks by the U.S. Court of Appeals for the District of Columbia; an appeal is being taken to the Supreme Court.

Banks are specifically promoting the sale of large quantities of commercial paper, and in exchange receive a commission from the issuer directly related to the size and success of the distribution, an activity that falls within the classic definition of distributing or selling. In addition, the promotional efforts to place these securities with investors along with the "salesman's stake" amount to at least "best efforts" underwriting of this corporate security.

Despite assertions to the contrary, commercial paper and the short-term commercial loan markets have both grown along parallel paths in recent years. Foreign banks have probably had more impact on domestic bank lending to prime borrowers than commercial paper has.[11]

Underwriting commercial paper is not without risk. Commercial paper issuers have gone bankrupt leaving behind a legacy of liabilities to underwriters and distributors, particularly under the securities laws, because sellers of commercial paper impliedly warrant the creditworthiness of the corporate issuer. This type of failure could lessen depositors' confidence in a bank, particularly when the paper is sold to individual or institutional customers of the bank, or upon the bank's advice or where the bank is also lending to the issuer, or uses the proceeds to pay off existing bank loans.

Tying the backup letters of credit to underwriting and distribution of the commercial paper of an issuer creates an even more insidious problem. It places the bank's credit behind the issuer thereby guaranteeing the paper, and given the rescue of Continental Illinois it does the same with the federal government's credit. Will banks demand (or request) underwriter status before issuing a letter of credit to back up commercial paper? Linkage of underwriting and credit facilities already exists in the municipal general obligation commercial paper market.

The pecuniary incentive in marketing bank sponsored commercial paper would impair the bank's ability to act as a source of disinterested credit and financial advice. The size of the stake is directly related to the amount of commercial paper distributed. In order to maintain its distribution system a bank may purchase unsold notes for its own account or for accounts over which it has discretion, or force it upon correspondent banks. Maintaining a large distribution is essential given the large volume of commercial paper issued each year.[11]

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[11] See Securities Industry Association v. Board of Governors, 104 S. Ct. 2979 (1984).

[11] Statement of Federal Reserve Board Chairman Paul Volcker before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations (June 11, 1986) p. 13 (hereafter " Volcker Statement").

[11] The Federal Reserve Board has recognized these dangers, and has attempted to limit them, in the case of the Bankers Trust litigation.

V. Banking Myths of Today

Every era creates its own myths and the bankers of today are especially active. "There are structural problems in banking which prevent us from being profitable. We are doing all we can and still cannot make a go of it. Securitization is doing us in. We will lose out globally if we cannot get into the U.S. securities business. The Japanese banks are invading America and have an unfair advantage."

There are equally short answers: "There are many opportunities for service and profit in banking. Many, many well-managed commercial banks in the United States are doing very well. Banks have been given their special advantages so they can serve the businesses and consumers who rely upon their franchise. Businesses and consumers are speaking out for better banking services and many are not getting them. Letting banks opt out of banking is not the answer. That federally-insured deposits fund international securities activities is bad enough and is no argument for doing the same at home. Japanese banks operate in their country under a Glass-Steagall equivalent and in this country under the same rules as American banks. The Japanese banks are not more profitable than ours."

1. The Banking Franchise Is Still A Public Trust

Every business has its ebbs and flows. Needs change over time. Banks and their customers are no different. What was needed yesterday may not be needed today. Banks have been given a franchise to seek out and serve the banking needs of businesses and consumers, which are constantly changing. This is why they have been given their special advantages, such as access to the Federal Reserve discount window and federally insured deposits and a web of regulation that inspires trust and confidence in the banking system. Much like a utility, a bank has a franchise to serve. When the needs of the constituency change, bankers should not throw up their hands and seek to opt out of banking but seek to determine how best to adjust their services to take care of the needs of those they are franchised to serve.

In times of peak demand banks may have difficulty in serving both businesses and the consumer well. This is a time of transition for many businesses in the United States. Traditional borrowing in agriculture and energy is off due to poor conditions. Some of our largest banks have not priced their loans attractively enough to keep their favored borrowers and have lost some of them to commercial paper and bonds. However, consumer demand is at an all time high and many small and medium-size businesses need a helping hand from a willing banker. Indeed, from recent reports it appears that interest income is growing quite satisfactorily for many banks. And yet, despite the opportunities presented for banks to devote needed attention to serving the consumer well, too many of them are not doing so. The nationwide complaints about credit card interest rates show consumer dissatisfaction and the credit card portfolio losses of some banks seem to indicate careless management of that business.

For the last several years many banks have faltered and even failed because of imprudent management and risky ventures. From Continental Illinois and Penn Square to the Bank of America mortgage backed securities fiasco, to the more than doubling of bank fraud cases in the past few years, many banks have not shown themselves to be wise protectors of their depositors' funds even in traditional banking ventures. The thrifts have had their problems too, as seen in the Maryland and Ohio thrift crises. More banks failed last year--138--than at any time since the Great Depression. They did not fail because they could not get into the securities business. They failed due to unsound management and the public's loss of confidence in the safety of their deposits. Banks should be saved, if at all, so they can perform their banking franchise.

At a time when bank regulators are asking banks to increase capital to cover existing risks, banks should not be trying to raise more capital to get into even more risky businesses such as securities underwriting. Bank holding companies have been borrowing funds to invest in the equity of their subsidiaries, relying upon dividends to earn debt service. Credit rating agencies and regulators are already concerned about this "double leveraging" for bank subsidiaries. How much more of a problem it would be for subsidiaries engaged in the volatile securities business?

2. "Go-go Banking" Is Not Serving the Consumer

How is banking doing its job? A recent issue of the New York Times headlined, on December 14: "Now, the Age of Fast-Buck Banking." The article lists among its "snapshots of new American banking practices, 1986": the flooding of consumers with unneeded credit cards, the use of misleading teaser interest rates to lure customers to variable rate mortgage loans, ads urging people to borrow heavily against their homes as collateral without warnings of the risk of overborrowing, high monthly fees for consumers who keep less than $20,000 in their savings accounts, and misleading statements of check charges. Class action suits have been brought in California charging banks with misrepresentation of the real cost of mortgage loans.

Consumer representatives are alarmed. In the same article Steven Brobeck, Executive Director of the Consumer Federation of America, stated, "The proportion of banking institutions that are obeying the letter but not the spirit of the law in their marketing practices has increased significantly over the last 10 years." Because of the guaranties of the federal government, consumers expect banks to be "in part at least public trusts," with different standards of behavior. Yet too many banks consistently resist measures designed to ensure that they conduct their activities fairly. The banks blocked the Federal Reserve's proposed guidelines for fuller disclosure in bank advertising. They resisted legislation to reduce the delays in checkholds and to reduce unconscionably high credit card interest rates, and even legislation requiring more public information about credit card costs.

In the 1984 hearings of this Committee on S.2181, Senator Garn's bill that would have given banks new powers, the Consumer Federation of America urged a "go slow" policy based on existing problems in the bank system and concern for excessive concentration of power and tying of products if banks could enter new fields.[14] The American Association of Retired Persons testified as to its concerns for the safety and soundness of banks entering new activities and the unfair advantages banks have in competing with other entities. Without a complete reform of the deposit insurance system, AARP testified that Congress should not widen the powers of bank holding companies.[15] In 1985 testimony before this Committee on similar issues, the AFL-CIO testified that dealing in revenue bonds and mortgage backed securities "would again invite the sort of dangers which led to the Glass-Steagall Act in the thirties."[16] Faced with these specifically articulated concerns, it is disingenuous for banks to argue that their special interest proposals are based on a concern for the consumer.

There is plenty of work for banks to do in banking. Do we want banks to abandon their special role of serving the banking needs of business and the consumer? That is a danger if banks are permitted to go outside of banking. They will be diverted and their basic and central role in our economy will suffer.

3. Bank Profitability Is Not Declining

While some banks are complaining of inadequate powers, many well-managed banks are operating profitably. They have adjusted to their shifting business customer base, they have expanded their consumer lending (if tightly managed, more profitable than business loans) and have converted some lending business to service business by liquifying loan portfolios through securitization. (Securitization creates more lending opportunities for banks--their funds are not tied up--and it reduces their interest-rate risk.) Some have developed specialized banking services for particular industries, e.g., trust services for mutual funds, and are doing very well.

Despite the trends to securitization and junk bond financing, all large banks (banks with assets over $1 billion), excluding the nine money center banks, had their 15-year high return on equity in 1985. The top money center banks did not do as well principally because of increases in their loan loss provisions, in large part due to setbacks in overseas activities.

In recent months, a few banks have claimed that they will drop their charters in order to enter the securities business. This threat is suspect in light of recent reports of bank profits. For example, on January 15, the Wall Street Journal reported that five big banks (Chemical, First Chicago, Bank of New England Corp., Continental Illinois, and Barnett Banks of Florida) had fourth-quarter earnings gains last year of 4.9% to 30%. In the same article Keefe, Bruyette & Woods, a securities firm specializing in bank stocks, predicted that "profits at the country's 170 largest banks will rise 9% to 10% in the fourth quarter of 1987 and 11% to 12% for the year.

On January 16, the Wall Street Journal reported that six more banks reported higher fourth quarter earnings, posting increases of 9.3% to 26% from a year earlier. (These banks are

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[14] "Competitive Equity in the Financial Services Industry," S. Hrg. 98-629, Part II, 98th Cong. 2d Sess., February 29, 1984, at 988-995.

[15] Id. at 999-1015.

[16] "Comprehensive Reform in the Financial Services Industry," 99th Cong., 1st Sess, June 11, 1985 at 67.

First Bank System, Marine Midland, Bank of New York, NBD Bancorp., J.P. Morgan and First Union). Increases in net interest income were common. According to the January 16 American Banker Marine Midland attributed its 26% jump mostly to improved net interest income, vindicating its strategy to focus on "higher return domestic businesses, primarily consumer banking, middle market banking, and asset-backed financing."

Seven other major banks reported higher 1986 fourth quarter earnings just this week. The January 21 Wall Street Journal noted that, among them, Citicorp became the first U.S. bank holding company to break the $1 billion mark in annual earnings. Citicorp noted that its "traditional corporate banking business also had an earnings increase," in addition to increases in consumer banking and institutional investment operations. Net interest income also figured in the increases for Chase Manhattan, Manufacturers Hanover, Bankers Trust, Wells Fargo, and Bank of Boston.

Japanese banks are profitable and have emerged as world leaders in banking, yet they are subject to their own Glass-Steagall Act equivalent and to the Bank Holding Company Act here. They seem to operate their banks more tightly, with less overhead. One recent bank study showed noninterest expense for a typical Japanese city bank to be less than one-half that for an American money center bank.

In fact, the profitability of U.S. banks compares favorably with banks located in major industrialized countries. For example, in 1985, the average return on equity for the 132 U.S. banks in the top 500 in the world was 13.5% whereas the return of the 62 Japanese banks on the list was only 7.5%.[12] The same survey showed that not one Japanese bank ranks in the top ten in rank by net income, whereas five out of ten were U.S. banks. (Arguments based on the growth in Japanese bank assets are dramatically overstated due to the dramatic increase in the value of the yen during these last two years.)

The answer to changing conditions in banking is not to divert bankers from banking. The need in banking is for what it has always been, good management.

4. "Globalization" of Securities Markets Does Not Argue For New Bank Powers

Another argument used to attack Glass-Steagall is the internationalization of capital markets. Jill M. Considine, New York State Superintendent of Banks, for example, stated as her rationale for opening up the New York State "little Glass-Steagall" Act: "In light of the liberalization of global capital markets, the United States is now at a distinct competitive disadvantage due to the Glass-Steagall Act, and the focal point of the financial services market is beginning to shift to London and Tokyo."

This is pure misinformation. The participation of financial institutions of one country in the capital markets of another does not mean that the United States should drop its own established safeguards to prevent the hazards and conflicts of interest in commercial banks' participation in the securities industry. Nor should it keep the United States from preventing unfair competition between investment banking and commercial banks within our nation. Nor should it lead the United States to expand risks to the insured depository system.

The charges as applied to Japan are perhaps the most misleading. Japan has, if anything, a more rigid wall between its banks and securities firms than the United States. The Japanese had "universal banks" until the post-war American occupation broke up the economic concentration of power they represented. Article 65 of Japan's securities and exchange law----their version of Glass-Steagall---still stands despite pressures from Japanese banks, largely because of fears that the banks could drive out all but a handful of Japan's several hundred securities firms, reconstituting the high pre-war levels of concentration in the Japanese financial markets.

The banking industry has also tried to cloud the Glass-Steagall debate by misrepresenting the significance of London's so-called "Big Bang," which took place this fall. London's "Big Bang" simply followed the United States' model by eliminating London's division of brokers and dealers and fixed brokerage commissions. Brokers match up buyers and sellers and receive a commission for their efforts. Dealers take title and hold securities until they sell them for a profit. All the "Big Bang" did was to allow firms in London to become broker-dealers, as historically securities firms have been allowed to do in the United States.

The London market, like the Euromarket, has been eligible for bank participation for years. Indeed, the banking industry uses the argument that U.S. commercial banks can engage in activities overseas that they are prohibited from doing at home as a rationale for eliminating Glass-Steagall. But it is hard to see why banks are using this argument.

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[12] Euromoney, June 1986.

Permitting U.S. banks to participate in London and the Euromarket allows U.S. banks to use the advantage of a federal subsidy of insurance of their bank deposits to compete against American and foreign securities firms abroad. Simply because we have already put bank funds and federal insurance at risk in allowing such foreign securities activities by foreign subsidiaries of U.S. bank holding companies surely does not provide a basis for allowing them to compete unfairly with domestic securities firms in the United States. The Washington Post in a December 30 editorial agreed with the SIA position that "letting the banks into the underwriting business would be unfair because the banks can use their federally insured deposits to fund their lending." That we give our banks a leg up abroad should not be a rationale for giving them an advantage at home.

5. Sumitomo's Investment in Goldman Sachs Can Be A Model for U.S. Banks

Another international event that the banking industry has mischaracterized in order to attempt to gain support for eliminating Glass-Steagall is Sumitomo Bank Ltd.'s recent passive investment in Goldman, Sachs & Co. They ignore the fact that an American bank, under Glass-Steagall and the Bank Holding Company Act, could today make the same investment in an American securities firm.

In approving the agreement between Sumitomo and Goldman Sachs, the Federal Reserve noted that the Sumitomo investment had "raised perceived implications for administration of the Glass-Steagall Act." But it answered that a "truly passive noncontrolling investment" such as that entered into by Sumitomo "logically should not raise any Glass-Steagall issues."

The Fed was in fact well aware that its approval of this transaction would set a precedent for U.S. banks to follow. The Fed therefore made its approval contingent on a determination not only that Sumitomo could not exercise a controlling influence over Goldman Sachs' policies, but also that if this model were followed in the future by U.S. banks, it would not adversely affect the safe and sound operation of domestic banking organizations. To this end it imposed a number of stringent conditions on the transaction, including a requirement that the Sumitomo bank holding company increase its capital by an amount that would substantially offset the funds invested in the securities firm, so that it could

continue to provide a source of strength to its subsidiary banks if this investment proved unsound.

The Securities Industry Association has testified that it welcomes the investment by other providers of capital, domestic or foreign, including U.S. banks, in the American securities industry under similar safeguards to those in the Sumitomo/Goldman Sachs transaction. Under the conditions imposed by the Fed, including an increase in bank capital to cover its investment in a securities firm, such investments could strengthen both industries without creating the risks, conflicts of interest and unfair advantages that would result if banks could directly enter further the business of underwriting securities.

6. The Rules of the U.S. Capital Markets Do Not Need Dramatic Changes

The United States has the largest and most successful capital market in the world. What matters is the players in this market all play by the same rules and, except for a handful of foreign banks grandfathered by the International Banking Act of 1978, all banks and securities firms play by the same rules in the United States. Of the foreign banks grandfathered under this Act, only one has shown any underwriting strength (with 0.2 percent of the market in 1986).

There are different rules in Tokyo and London. Whether or not these rules need to be the same is an open question. What is important is that within the national markets the rules be the same. The Glass-Steagall rules have worked very well for our capital markets and changes should not be undertaken before possible consequences are carefully examined.

The capital markets of this country operate extremely well, are highly efficient and intensely competitive. The burden of demonstrating the need for change is upon those who propose it. There is no question that the Glass-Steagall Act has been a beneficial force against the concentration of financial power. If we had followed the example of European banks, we would have only a few banks controlling our entire economic structure. The call for securities powers for banks have come from banks and bank regulators. Consumers and businesses have not joined in the clamor. It is up to Congress to set policy in the area after a full review of all the relevant factors.

7. The Current Regulatory Crazyquilt Does Not Provide Adequate Protection for New Bank Powers

Before any significant changes in the duties and responsibilities of banking organizations are considered, attention must be given to what regulatory oversight there will be and how much risk the federal government should be underwriting by its insurance of the banking industry. The regulatory scheme that would supervise bank entry into any new activities is still a patchwork of uncoordinated agencies. The Administration has stated that it soon intends to resubmit to Congress the recommendations contained in the 1984 Bush Task Force Report to create a rational system of "functional regulation" of banking activities. These proposals would consolidate and reorganize the Federal Reserve Board and the FDIC and replace the Comptroller of the Currency with a new federal banking agency.

Most importantly, under the Bush proposals regulation of the securities activities of banks would be taken over entirely by the SEC, rather than being split with banking regulators as at present. This is urgently needed following the American Banking Association's unfortunately successful challenge last fall to the SEC's first tentative steps in this area. The D.C. Circuit in November struck down SEC Rule 3b-9, adopted in 1985, which required banks engaged in securities brokerage to register as broker-dealers under the 1934 Securities Act. The Court agreed with the public interest rationale for SEC regulation of these new activities, but felt that the Securities Act of 1934 would have to be amended to achieve this end. Like SIA, the Court urgently called upon Congress to "undertake a comprehensive reexamination of the Glass-Steagall Act and the Securities Acts," given the domestic changes in over 50 years since both were adopted.

The Vice President's chief counsel stated in December that enactment of the Bush Task Group reforms would be an important step towards making Congress feel more comfortable about allowing banks into new securities activities currently prohibited under Glass-Steagall. SIA agrees that any rational approach to expanding bank securities powers must first take a hard look at the bank supervisory agencies and their capacity to handle oversight of any new powers. Congress is surely putting the cart before the horse by looking at the new powers issue before considering at these proposals for structural banking regulatory reform.

8. The Separate Subsidiary Concept Does Not Solve the Safety and Conflict Problems

The idea of granting banks additional securities powers, provided such activities are carried on in a separate securities affiliate of a bank holding company into which the affiliated bank would have to transfer its presently authorized underwriting activities, was first advanced by Secretary Regan in testimony before this Committee on October 19, 1981.

SIA gave a qualified endorsement to the concept of a separate subsidiary in 1981, but only if the Congress, after careful and full consideration, decided to grant additional securities powers to banks. At the risk of being repetitious, we repeat our view that it is contrary to the public interest to grant such additional powers to banks. However, the separate subsidiary approach is a preferred alternative to having the securities activities conducted in the bank.

The presumed advantages of a separate securities affiliate are two-fold -- to protect the safety and soundness of the bank and the banking system and to provide an environment in which bank securities affiliates and other securities firms can compete on fair and equal terms. We are skeptical that either objective can be fulfilled.

a. Failure to Protect Bank Safety and Soundness

The first objective assumes that a bank could allow a securities affiliate to fail without attempting its rescue, or that such a failure could occur without substantial consequential harm to the affiliated bank. Mr. Walter Wriston, then Chairman of Citicorp, shares our skepticism. Commenting on the concept of a separate securities affiliate in testimony before your Committee on October 29, 1981, he stated:

> A holding company is probably the clumsiest, most expensive way that exists to operate any business. We have only gone to a holding company in order to comply with the law, and gain some flexibility by so doing. But it is a very poor way to

> operate. For example, it is inconceivable that any major bank would walk away from any subsidiary of its holding company. *If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.*
>
> So I don't see any benefit in getting a separate subsidiary for new businesses . . . I don't see any benefit from it myself.
>
> I would go just the other way. If the National Bank Act was amended to say that everything a bank holding company can do, the National Bank can do, I'd be extremely happy. *It would simplify administration and would make it perfectly clear to the customer that our $7 billion capital is behind everything that we do* . (Emphasis supplied.)

Chairman Volcker makes a similar observation: "In the nature of things, parts of an organization under common management and in public perception related to each other, will, to a considerable degree, be affected by the fortunes of other important parts of the same organization." [11]

b. Unfair Bank Advantages Remain

The second objective of providing a fair field of competition between bank securities affiliates and securities firms cannot be achieved without prohibition of the flow of capital and business relationships to the affiliate.

Securities firms facing competition from bank securities affiliates have legitimate cause for concern about whether fair competition will prevail. Banks can and do extend credit to their affiliates in amounts and on terms that other firms might never obtain. To reassure Congress and regulators that nonbank affiliates would not enjoy an unfair advantage, bankers

frequently cite Section 23A of the Federal Reserve Act, which generally is intended to require adequate collateralization of loans by member banks to their affiliates. But Section 23A, which was "liberalized" by the "Banking Affiliates Act of 1982," is hardly even a mild restraint on bank loans to affiliates.

First, transactions between a bank and its majority-owned non-bank subsidiaries are not even "covered transactions" subject to Section 23A. Second, many transactions that otherwise would be "covered transactions" are expressly exempted, for example, a bank loan to an affiliate that is fully secured by U.S. Government obligations. Third, the quantitative limitations on covered transaction -- 10% of a bank's capital stock and surplus on credits to any single affiliate and 20% on credits to all affiliates -- are far from onerous.

A few current examples drive this point home. Based on their respective 1984 annual reports, a major New York bank had authority under Section 23A to lend $278,880,000 in covered transactions with affiliates, while a major California bank had authority to lend $434,618,400. Section 23A, moreover, does not restrict loans by a bank holding company to its nonbank subsidiaries of funds derived from dividends received from the banking subsidiary, nor does it regulate interest charges on covered transactions.

In short, the mere fact that a loan to a non-banking affiliate may be adequately collateralized, or funded by bank dividends, is little comfort to a competitor of the affiliate. Section 23A may reduce the risk of a bank failure, but it does not redress the resulting inequity when bank affiliates have access to loans on preferential terms, and sometimes whether one can borrow any funds at all, not their cost, is the critical consideration.

Chairman Volcker has also expressed skepticism about the effectiveness of Sec. 23A:

> Congress can of course legislate barriers between a bank and its affiliates, and has in fact done so by limiting inter-affiliate loans under Sec. 23A of the Federal Reserve Act. But, under pressures to maintain the viability of their organization, management can and does

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[18] Volcker Statement, p. 13.

find ways to support an affiliate that does not involve intercor- porate lending. Simply strengthening section 23A in the expectation that this would enforce true corporate separateness is naive . . . " [19]

Chairman Volcker in his cited testimony had some additional observations to make about the conflicting objectives of those who seek true separateness between banks and their holding company affiliates and those whose aim is to realize the maximum potential synergisms the holding company complex has to offer:

> Only if Congress required such limitations as completely different names for holding companies and affiliates, no management interlocks, explicit disclaimers on affiliate obligations, no tandem operations, and other such efforts to enforce true corporate separateness, would market participants -including management itself -- really begin to think of bank subsidiaries as separate and not put at risk by the activities of their affiliates. Such limitations, however, would turn the nonbank affiliates of regulated bank holding companies into portfolio investments. Without the perception or reality of synergy between the bank and its affiliates, interest in such affiliates would surely decline sharply. Conversely, the strong interest by some commercial or financial firms in banks, or by bank holding companies in a more fully diversified financial services structure, reflect the perception of "synergy" and inter-relationships. [20]

VI. A Level Playing Field?

SIA has considered what might be the terms on which banks could enter into securities underwriting in a fair manner. SIA has expressed doubts that the advantages that banks have can be completely neutralized, but it believes that what it has

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[19] Id., p. 24.

[20] Id., p. 24,25.

proposed could go a long way to achieving competitive equity. As noted, even the Federal Reserve Board doubts that the banking system can be insulated from securities activities by the separate affiliate approach, which means federal regulators insuring such business.

In any event, the following are some factors which SIA believes are essential should Congress ever decide that banks should be allowed to underwrite some or all of the securities currently proposed:

1. A separately-capitalized subsidiary of the bank holding company would be required to carry on all the securities activities of the bank holding company complex: brokerage, trust fund and pension management, underwriting and dealing of all securities.

2. Only the initial capital would come from the bank holding company. Subsequent equity and all loans would come from outside the bank holding company complex.

3. The SEC would regulate all of the activities of the securities subsidiary.

4. No officers or employees should be permitted in common, and directors in common would be allowed only to the extent permitted in similarly sensitive situations under the Investment Company Act. No exchange of material non-public information would be allowed.

5. No purchase or credit transactions between the securities subsidiary and its affiliates would be permitted.

6. If the securities affiliate is involved in a transaction, no other affiliate could be involved to provide credit facilities or other services. No joint marketing would be allowed. The reverse would be true as well.

7. Where there is a common customer no affiliated bank could fund the payoff of any security underwritten or placed by the securities affiliate.

8. The securities activities of the securities affiliate should not be so great in relation to the banking activities of the bank holding company complex as to raise concerns about the risk exposure of federally-insured deposits.

9. Perhaps the federally-insured deposits of affiliated banks should be put in trust and invested solely in U.S. Government securities to provide complete insulation from securities risk.

10. Perhaps securities firms should have access to the discount window at the Federal Reserve and be able to take federally-insured deposits.

VII. What is Really Going On: What Answers are Needed?

What is being sought by the large banks of this country is really the repeal of Glass-Steagall for banks. Banks are seeking power at this time to underwrite virtually everything which the Glass-Steagall Act prohibits except all corporate debt and equities. This is no small change. In D.C., New York and Delaware they are seeking full corporate powers as well.

In this one-way clamor for new securities powers for banks, we cannot forget that this has been since the 1930's, and remains, a very complex matter. Safety and soundness of banks, unfair advantages for banks, conflicts and concentration of economic power are just some of the basics involved. Congress split commercial banking and investment banking apart with the lessons of history fresh in its mind. We recognize that 50 years is a long time and SIA has for years called upon this Committee for a complete review of the Glass-Steagall Act and the other banking and securities laws governing the relationship of commmercial banks and investment banks. We repeat that call today.

While Congress is considering these matters new loopholes in the Glass-Steagall Act should not be opened. The Federal Reserve Board is poised to grant applications of Citicorp and other major bank holding companies to participate in the kinds of underwritings being presently proposed for bank holding companies without benefit of congressional direction. Once a loophole is opened by regulatory fiat it becomes increasingly difficult for Congress to close it. The nonbank bank loophole is a prime example. Therefore, to preserve the options of Congress in determining what should be done, the so-called "engaged principally" loophole should not be opened by the Federal Reserve Board.

What is being urged upon Congress is truly momentous. A major blow is being aimed at Glass-Steagall. Private mortgage-backed securities are like corporate debt. Commercial paper is a corporate security. Revenue bonds are not government supported either and are prime subjects for bank tying arrangements.

If Congress determines that the banks cannot by skill and intelligent effort keep themselves healthy, it should consider for itself what kind of assistance is in the best interest of the country. Just because banks have a stated preference for getting into securities underwriting is no reason for Congress to conclude that the best place to put banking energies outside of banking. Congress, after adequate review, should decide what the new directions and new structures should be. Those who are seeking change have the burden of demonstrating the need for it. As yet, they have not met that burden.

There are a number of approaches being presented to satisfy the desires of a small number of financial institutions to be "all things to all people." These include:

-- the Treasury's separate subsidiary concept as embodied in S. 2592, as introduced in the 99th Congress,

-- the concept of a financial services holding company as envisioned by the Association of Bank Holding Companies,

-- the American Bankers Association's concept of a bank service corporation acting separately from the bank or bank holding companies which would be able to underwrite securities,

-- Robert Litan's concept of a narrow fail-safe bank which would collect insured deposits and invest them in short-term securities while there would be a separate subsidiary for lending and securities activities, and

-- the double debanking concept developed by Karen Shaw and apparently endorsed by Chase Manhattan Corporation in which separate subsidiaries would engage in underwriting and lending, but would not be part of or operate out of a unified corporation.

There may be other approaches and concepts. Obviously reinforcing the separation between banking and commerce is still yet another.

These proposals as does the proposal to grant new securities powers to banks raise a host of issues which have not been examined and must be examined before any major changes in Glass-Steagall can be considered and new structures designed. Such as:

- How can the rest of us be protected against the unfair tying arrangements that banks constantly deal in but are rarely caught at? The situation will be worse the more activities outside of banking they can be involved in.

- What kind of problems will these new ventures create for the banking system as a whole?

- How can we shield banks, the insured deposits of investors, the U.S. Treasury and the taxpayers from the cyclicality and volatility of the securities business?

- Who can own a financial services holding company?

- Who will regulate a financial services holding company? Who will regulate securities affiliates? How complicated will the new regulatory arrangement have to be to take care of this much more complicated set of structures?

- How will conflicts be handled within the structure, and will simple disclosure work? Will secrecy about internal bank problems continue to be the order of the day?

- How do we neutralize the cost-of-money advantages that banks have?

- How do we ensure that other financial institutions will not be subjected to unfair bank competition?

- How do we initially capitalize subsidiaries or affiliates? How do we gauge capital adequacy for banking and the other permitted ventures? How do we isolate banking capital so that it will be available for banking purposes?

- How do we provide continuing capital for the new securities affiliate, since clearly it would be unfair for it to obtain it from an affiliated bank? Will the problems presented by "double-leveraging" be compounded?

- What role do nonbank banks play within the structure?

- Should national treatment vis-a-vis Japan and Germany be resolved in this system? Should change in Glass-Steagall be coordinated with changes in Japan's Article 65?

- What advantages are there for the public, the consumer and business in these changes?

- What benefit is there for industries that will now be faced with bank competition in their businesses? Should they be granted power to enter banking?

- What impact will these changes have on control of monetary policy?

- Should all Glass-Steagall loopholes be plugged so as to bring all financial institutions under the same rules, including state-chartered insured banks and thrifts?

- How do we ensure that allowing banks into new fields will be pro-competitive and not just a step on the road to greater concentration of financial power?

Some of these questions are the direct result of the newly proposed structures, but a good many must be asked about our present system before any major changes are considered. In addition, a number of old questions remain uninvestigated and unresolved as well. To continue:

- Banks claim they need new powers to remain profitable. Are banks really unprofitable? Recent evidence would suggest that they are not.
- Are domestic banks really uncompetitive internationally? U.S. banks rate high in the world in terms of profitability. Asset growth of Japanese banks is largely a result of the increased value of the yen.
- What are the real problems within the banking system?
- Are there banking problems that cannot be solved within the present banking structure? Why is it that so many well-run banks are doing well if there are structural problems? Is securities underwriting the answer for agricultural and energy loan problems?
- Why cannot banks meet consumer needs under the current banking system?
- Do we really want to trade a diverse and varied financial system for a universal banking system with the economic power concentrated in the hands of a few?
- What would be the effect on consumers and small and medium-sized businesses if banks are allowed to go afield from banking?
- Can we imagine a better result from any other set-up than Glass-Steagall has given us: a sound banking system, capital markets second to none and financial power spread across two separate industries?

- How does one effectively eliminate unfair bank advantage (e.g., tie-ins) when banks operate outside of banking? It has not been done yet.

Regulators, rather than Congress, are making policy in these areas. They are redesigning the financial system of this country without adequate attention to these issues and without direction from the appropriate policy-maker, Congress. They appear to be responding to the wishes of their constituents, the banks. The "engaged principally" applications being orchestrated by the Federal Reserve Board are prime examples of how far afield regulators are wandering from clear congressional intent. A comprehensive review of all the laws that govern our financial services marketplace. This is the essential first step which Congress should now take. In the meantime the regulators should be told not to usurp congressional prerogatives and to foreclose congressional options. Following such review, Congress should develop a legislative solution to deal with the real problems in the banking system and not just what bankers want.

It is possible that the fair thing is total repeal of Glass-Steagall. Securities firms then could operate fully in the banking business. Total repeal at least would be a two-way solution and not the one-sided repeal being sought by the banks. SIA does not believe that full or partial repeal of Glass-Steagall is the right answer, but full repeal is better than partial repeal.

Glass-Steagall has brought us a financial marketplace of unequalied depth, diversity and strength. In fact, Glass-Steagall has been so successful, it is hard to believe than anyone is seriously proposing that it be changed. Indeed, a fair and impartial review may well lead to a strengthed and reinforced Glass-Steagall.

In any event, we hope Congress will ignore the misleading scare stories being circulated as a prod to push Congress to act in haste. The sky is not falling. Internationalization and securitization do not foretell the end of the world. Good banks are continuing to make good money in banking. Bankers will be able to succeed without a new "go-go" image.

Congress should not act in haste. The Glass-Steagall Act has served this nation well for more than 50 years. No crisis is forcing Congress to act before it has given these matters adequate consideration. We trust that Congress, should it conclude that changes are called for, should fashion the laws governing the relationship of the banking and securities industries in such a way as to ensure a sounder banking system and the continuation of the best capital markets in the world.

APPENDIX A

History of SIA Testimony Before Congress

1. Hearings Before House Committee on Banking and Currency, 88th Cong., 1st Sess. (1963).
2. Hearings Before House Committee on Banking and Currency, 89th Cong., 1st Sess. (1965).
3. Hearings on S.1306 Before Senate Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency, 90th Cong., 1st Sess. (1967).
4. Hearings on Trading in Municipal Securities Before Senate Subcommittee on Securities of Committee on Banking, Housing and Urban Affairs, 93d Cong., 2d Sess. (1974).
5. Hearings on Bank Holding Company Legislation and Related Issues Before House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of Committee on Banking, Finance and Urban Affairs, 96th Cong., 1st Sess. (1979).
6. Hearings on Financial Institutions Restructuring and Services Act of 1981 Before Senate Committee on Banking, Housing, and Urban Affairs, 97th Cong., 1st Sess. (1981).
7. Hearing on Competition and Conditions in the Financial System Before Senate Committee on Banking, Housing, and Urban Affairs, 97th Cong., 1st Sess. (1981).
8. Hearings on Securities Activities of Depository Institutions Before Senate Subcommittee on Securities of Committee on Banking, Housing, and Urban Affairs, 97th Cong., 2d Sess. (1982).
9. Hearings on Competitive Equity in the Financial Services Industry Before Senate Committee on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. (1984).
10. Hearings on Financial Deregulation Before House Committee on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. (1984).
11. Hearing Before House Subcommittee on Telecommunications, Consumer Protection and Finance of Committee on Energy and Commerce, 98th Cong., 2d Sess. (1984).
12. Hearings on Comprehensive Reform in the Financial Services Industry Before Senate Committee on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. (1985).

APPENDIX B

SUMMARY OF SIA LITIGATION ON GLASS-STEAGALL ISSUES

COMPLETED LITIGATION

PORT OF NEW YORK AUTHORITY V. BAKER, WATTS & CO.

In 1963, the Comptroller of the Currency issued regulations authorizing national banks to underwrite and deal in revenue bonds including those issued by the Port of New York Authority. The Court of Appeals ruled that bonds issued by the New York Port Authority were not regarded as "general obligation" bonds for Glass-Steagall Act purposes, and therefore cannot be underwritten by banks.

INVESTMENT COMPANY INSTITUTE V. CAMP

(ICI I)

In 1965, Citibank submitted for Comptroller of the Currency approval of a plan for collective investment of managing agency accounts. The Comptroller approved the plan under regulations promulgated in 1963 permitting managing agency accounts. The Supreme Court decided that the creation and operation of collective investment funds constituted underwriting, selling or distributing of a security or stock in violation of Sections 16 and 21 of the Glass-Steagall Act. The court outlined a number of subtle hazards and potential hazards that were present and intended to be eliminated by the Glass-Steagall Act. The court noted that the Act was a "prophylactic measure" and the legislative history compelled the court to examine the subtle and potential hazards presented by this banking activity.

NEW YORK STOCK EXCHANGE, INC. V. SMITH

In 1974, the Comptroller issued an opinion approving bank participation in automatic investment services whereby amounts of monies would automatically be deducted for a customer's checking account on a monthly basis and invested in one of 25 preselected stocks. The District Court found this activity to be permitted by Section 16 of the Glass-Steagall Act, but on appeal the case was remanded to the District Court with instructions to dismiss the case on the basis that the agency action challenge was not ripe for review.

BOARD OF GOVERNORS V. INVESTMENT COMPANY INSTITUTE

(ICI II)

In 1972, the Board amended its 4(c)(8) regulations to permit bank holding companies and their non-banking subsidiaries to serve as investment advisers to investment companies. In addition, by regulation it permitted sponsorship of closed-end investment companies. The Supreme Court held that a bank holding company or one of its non-banking subsidiaries providing investment advice to funds was conducting a banking activity not prohibited by either Sections 16 or 21 of the Act. In addition, the court determined that investment advisers of closed-end investment companies were not "principally engaged" in the issuance or securities within the meaning of Section 20.

SECURITIES INDUSTRY ASSOCIATION V. BOARD OF GOVERNORS

(Commercial Paper I)

In 1979, the Board issued a letter declaring that commercial paper was not a security within the meaning of the Glass-Steagall Act thereby permitting Bankers Trust to sell third party commercial paper. The Supreme Court held that commercial paper was a "security" under the Glass-Steagall Act. The court found commercial paper to fall within the literal meaning of the term "note" found in Section 21 and rejected the Board's functional analysis because it ignored the role of the bank in underwriting commercial paper.

SECURITIES INDUSTRY ASSOCIATION V. BOARD OF GOVERNORS

(Schwab Case)

In 1982, the Board permitted BankAmerica Corp. to acquire Charles Schwab & Co., Inc., the largest discount broker in the U.S., under Section 4(c)(8) of the Bank Holding Company Act. After a hearing, the Board found discount brokerage sufficiently "closely related" to banking to constitute a permissible activity for a non-bank subsidiary of a bank holding company. The Supreme Court upheld the Board's position giving deference to the Board's interpretation of the Bank Holding Company Act and finding that discount brokerage was not prohibited under the Glass-Steagall Act.

SECURITIES INDUSTRY ASSOCIATION V. CONOVER

(Conover I)

In 1982, the Comptroller approved applications of national banks to establish operating subsidiaries to provide discount brokerage services on a nationwide basis. The Supreme Court decided that discount brokerage falls within the permitted activities of Section 16 and that branching restrictions on national bank activities found in the McFadden Act do not apply to this activity.

SECURITIES INDUSTRY ASSOCIATION V. FEDERAL HOME LOAN BANK BOARD

In late 1981, a group of savings and loan associations filed an application with the Federal Home Loan Bank Board (FHLBB) requesting authorization for them to establish a third-tier service corporation broker/dealer to provide brokerage services to the savings and loan industry. The FHLBB approved the application. The U.S. District Court for the District of Columbia held that Section 21 of the Glass-Steagall Act did not prohibit this activity in a subsidiary of a savings and loan service corporation nor did it violate any provision of the Homeowners Loan Act. No appeal was taken from the District Court opinion.

PENDING LITIGATION

INVESTMENT COMPANY INSTITUTE AND SECURITIES INDUSTRY ASSOCIATION V. FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC Case)

After a long rulemaking proceeding, the FDIC adopted rules permitting state chartered non-member banks to establish separate subsidiaries to engage in a broad range of underwriting activities. The Court of Appeals has just affirmed the FDIC rules on the basis that Section 21 prohibitions attach only to the depository institution and not to separate subsidiaries.

SECURITIES INDUSTRY ASSOCIATION V. BOARD OF GOVERNORS AND CHARLES SCHWAB (Schaefer Value Fund Case)

The General Counsel of the Federal Reserve Board issued an opinion letter to Lazard Freres' attorneys stating that he saw no problem with Charles Schwab (which is an affiliate of BankAmerica) assuming a role in the distribution of this newly-formed closed-end fund. SIA brought suit in the District Court of the

The following is a brief summary of the most recent SIA study results.

Summary
1984

Security Pacific:

Supplied letter of credit for 18 of the 19 issues for which it acted as a manager. (In the 19th, Citibank supplied the LOC for a Security Pacific client for which Security Pacific had three times that year already provided the LOC and acted as a manager.)

Citibank

Supplied letter of credit for six of the nine issues for which it acted as manager.

Chemical

Supplied letter of credit for four of the eight issues for which it acted as a manager. (In one of the other deals Citibank supplied the LOC.)

The CHAIRMAN. Thank you, sir.

Mr. Silver.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. SILVER. Mr. Chairman, good morning and welcome back.

I would like to start, Mr. Chairman, by perhaps picking up where you left off in your opening statement.

Mutual funds—bank-sponsored mutual funds—were part, a central part, of the financial firestorm which swept this country between 1929 and 1933. It was perhaps for that reason, and I think it was for that reason, that this committee, in 1984, specifically excluded mutual funds from the new securities powers that banks would have been granted by the bill reported by this committee.

Second, mutual funds are not included in the present applications pending before the Fed for additional securities powers, because I think the bank lawyers well understand that they don't want to add bad facts to bad law, and I think it is very bad law. I do not think this principally engaged loophole exists at all. We will attempt to make that case before the Fed and thereafter.

I would like to depart in the few minutes I have left, Mr. Chairman, from our written testimony to shift the focus from the 1933 Glass-Steagall Act to 1927, when, for the first time, Congress permitted national banks to enter the securities business as part of the McFadden Act. After all, it is the 1927 decision which you are now being asked to repeat. The circumstances, the environment, and the expectations of that time should be examined, because there is no doubt that the 1927 decision turned out to be a dreadful mistake.

LESSONS FROM THE 1927 EXPERIMENT

The first lesson to be drawn from the 1927 experiment is that the judgment to proceed with it was very easy to make. Despite the fact that banks had been historically barred from the securities business, the decision to permit bank entry followed two decades of agitation by the Nation's largest banks, which clearly conditioned general thinking on the subject. Moreover, through the continuous creation of loopholes during those two decades, it appeared to Congress in 1927 that, to some extent, it was merely being called upon to ratify a fait accompli.

I do not have to spell out the present parallel.

Second, there seemed to be an appealing case for granting broad powers to banks in 1927, because it appeared that banks had fallen on hard times. The bank failure rate, particularly banks located in agricultural sections of the country, reached record levels during the 1920's. Again, I need not draw the parallel.

Third, when President Coolidge signed the McFadden Act on November 25, 1927, the prevailing financial climate lent support to the argument that banks should be permitted to share in the extraordinary success of the securities business.

As reported in the New York Times of Sunday, November 17, 1927, volume on the New York Stock Exchange stood at record levels and the Dow was at an historic high. Any fair reading of the financial page that long ago Sunday showed all systems at go. The Times characterized the new law as generally providing modernized procedures. Indeed, a periodical, World's Week, referred to the regulation as a, and I quote:

> * * * phase of American's coming of age in a banking sense. The law is a recognition of modern conditions, and an attempt by the national legislature to relieve the banks of traditional restrictions which in no way contribute to safe banking.

Of course, there were a few Cassandras. The New York Journal of Commerce warned that the new law, "embarks the national banks in the hazardous business of investment banking without any proper protection."

The 1927 grant of securities powers to banks was also thought of as being a minor part of a broader bill dealing with more important issues. Indeed, it appears that the grant of securities powers in 1927 may have represented a consolation prize to the big banks in a bill which restricted their drive for interstate banking. Whether such parallel exists today lies in the province of this committee to decide.

I would end with the words of a repentant New York banker some years later, after the failure of the 1927 experiment. He testified, and I quote:

> My experience was that if I was doing it today, I wouldn't do it at all * * * but this is hindsight. * * * I think that the whole theory of affiliated investment companies with banks was a mistake * * *.

I hope and I trust that this committee is in a position to exercise wise foresight and is spared the necessity to exercise hindsight.

Thank you very much, Mr. Chairman.

[The complete prepared statement of David Silver follows:]

District of Columbia on the basis that this was a clear violation of the Glass-Steagall Act and the Bank Holding Company Act and also that Schwab failed to follow the correct procedures to obtain such permission. The District Court dismissed SIA's case saying that the fact that the Board of Governors of the Federal Reserve did not act upon this application means that there had been no final agency action on the question and suggested that SIA go back to the Federal Reserve and ask them to follow the proper procedures. SIA has appealed the lower court's decision to the Appeals Court. This case may become moot if Charles Schwab & Co., Inc. is sold by the bank holding company.

SECURITIES INDUSTRY ASSOCIATION V. BOARD OF GOVERNORS AND BANKERS TRUST CO. (Commercial Paper II)

This is the second half of the commercial paper litigation. After the Supreme Court ruled that commercial paper was a security within the meaning of the Glass-Steagall Act, the Board addressed whether Bankers Trust Co. was underwriting, selling or distributing this security in violation of the Act. The Board found that Bankers Trust was not. The District Court found that they were underwriting in violation of Section 21, and the Court of Appeals has reversed that decision on the basis that Section 16 permits the activity and that Section 21 only prohibits public distributions, not private placements of securities. The Supreme Court will be petitioned to review this case.

SECURITIES INDUSTRY ASSOCIATION V. BOARD OF GOVERNORS AND NATIONAL WESTMINSTER BANK (NatWest Case)

In June 1986, the Federal Reserve Board approved an application of National Westminster Bank PLC to form a wholly-owned subsidiary which would be a registered broker/dealer providing portfolio investment advice and securities execution, which in effect would make it a full-service brokerage firm. SIA appealed the Fed's decision to the Circuit Court of Appeals in the District of Columbia claiming that the combining of investment advice with transaction execution was a violation of both the Glass-Steagall Act and the Bank Holding Company Act. All briefs will be filed shortly and the case will be argued in March of 1987.

SECURITIES INDUSTRY ASSOCIATION V. CONOVER

(Conover II)

The Comptroller has on at least three occasions permitted banks to establish subsidiaries to offer discount brokerage and

investment advice. This case has been pending the resolution of Conover I and will probably continue to be dormant pending resolution of the NatWest case.

POTENTIAL LITIGATION

Bankers Trust Co.

On December 24, 1986, the Fed approved, with certain limitations, Bankers Trust's application to place commercial paper through a separate affiliate of the holding company.

Citing the Court of Appeals decision the previous day, the Fed stated the placement of commercial paper does not constitute "underwriting" or "selling" as prohibited by Sections 16 and 21 of the Glass-Steagall Act.

Most critically, however, the Fed also stated that even if the placement of commercial paper did constitute underwriting prohibited by Section 20, the separate affiliate set up by Bankers Trust would comply with Section 20 because it would not be "engaged principally" in such activity. The Fed defined "principally engaged" to mean "a substantial, even if not the largest, activity," thus rejecting arguments that only activities that constitute over 50 percent of the total activity of an entity are "principal" activities.

The Board combined a "gross revenue test" and a "market share test" to determine whether a subsidiary is "principally engaged." It found that the former reflected the level of risk involved in the activity and that both tests were less susceptible to manipulation than a test based on sales volume, as proposed in the Citicorp and other applications.

Using these criteria, the Fed found that the Bankers Trust proposal did not cross the principally engaged threshold when:

(1) its gross revenues from commercial paper activities in any one year constitutes less than 5 percent of its total gross revenues; and,

(2) the volume of commercial paper underwritten by that bank that is outstanding at any one time represents less than 5 percent of the average amount of all dealer-placed commercial paper outstanding during the previous four calendar quarters.

The Fed did not, however, determine whether this numerical threshold would apply in all other cases before it, thereby reserving a case-by-case determination.

FED HEARING

Applications of: Citicorp, Morgan Guaranty, Bankers Trust, Chemical Bank, and Manufacturers Hanover

One day after the Federal Court of Appeals ruling, the Fed called for hearings and invited SIA to testify on February 3, 1987, to determine whether Citicorp, J.P. Morgan, and other bank holding companies can underwrite mortgage-backed securities, municipal revenue bonds and consumer receivable backed securities through separate affiliates. It said it plans to render its decision on the issue by April, 1987. Chairman Volcker, in a separate statement, urged swift congressional action to amend Glass-Steagall.

The Fed distinguished the applications by Bankers Trust, Citicorp and J.P. Morgan from placement of commercial paper because the applicants intend to combine permissible U.S. government securities with otherwise impermissible underwriting in order to determine whether they were not "principally engaged" in underwriting securities under Section 20.

Specifically, the Fed is concerned that if it uses these applicants' proposed volume test, firms can manipulate the sales volume by "churning" the affiliates' dealing activity to make it appear that the affiliates are not "principally engaged" in impermissible underwriting. In preparation for the February hearings, the Fed requested information on the following:

(1) whether the tests in the Bankers Trust commercial paper case needs modification, especially where an affiliate that is also engaged in government securities is involved; and,

(2) whether the amount of capital a holding company may invest in underwriting activities should be limited, and whether capital devoted to underwriting should count toward meeting the holding company's regulatory capital requirements.

EXPANSION OF STATE NON-MEMBER BANK SECURITIES ACTIVITIES

On December 30, 1986, the Office of the Comptroller of the Currency announced that it has granted preliminary approval to three banks to operate under local licenses in the nation's capital. Because these banks can qualify under a loophole in a 1901 federal law that allows District banks to obtain a local license, rather than a state or federal charter, these banks will be able to offer a wide range of services, apparently including securities underwriting.

On December 30, 1986, the New York State Banking Department ruled that New York State's "little Glass-Steagall Act" permitted a state-chartered bank to be affiliated with a securities firm provided that its underwriting activities with respect to securities that could not be underwritten by a New York State chartered bank do not exceed 25% of its total underwriting activities. As a rationale for this action, the New York State Superintendent of Banks stated, "In light of the liberalization of global capital markets, the United States is now at a distinct competitive disadvantage due to the Glass-Steagall Act and the focal point of the financial services market is beginning to shift to London and Tokyo." It is an open question if this can be used to expand securities powers of state chartered banks that are members of a bank holding company system, or if conducted in a bank, whether it violates Sections 16, 20, or 21 of the Glass-Steagall Act.

APPENDIX C

Bank Letter of Credit Tie-In Studies

The key difference between a bank and any competitor is a bank's ability to take deposits to use in its own business---federally insured deposits at that---resulting in readily available and inevitably lower cost capital for all of its endeavors. Of course, they also have their captive markets, e.g., their investment portfolios, their trust departments, their pension funds and their correspondent banking relationships. Of increasing importance today is their ability to tie the extension of credit to other services which they offer, which in some cases can include underwriting.

Tie-ins hurt the consumer because they are coercive and therefore more expensive than if a company had an equal ability to obtain other services anywhere. Tie-ins hurt the economy by producing less competition between providers of financial services.

Because banks are the ultimate suppliers of credit in our economy, Congress has given them leverage that no other institutions have. Congress should not however, allow banks to use this leverage for purposes outside of their special function, as lenders of last resort. For example, there has been a tremendous growth in variable rate financings in the tax exempt market in recent years. The growth started when high inflation and high interest rates hit the single family mortgage revenue bond market in the late 1970s and the early 1980s. Economic conditions had pushed mortgage rates, even those funded by tax exempt bonds, to unaffordable levels. To bring those rates down, a new financing device, the "put bond," was developed. To make the put bond work, a letter or line of credit was essential.

In 1982 before the Subcommittee on Securities of this Committee SIA presented the results of some original research which showed that the use of letters of credit, (LOCs), in underwritings was on the increase and that some banks appeared to have unfairly taken advantage or benefitted from the unfair advantage of their positions as credit suppliers to leverage themselves into management positions in underwriting groups for bank eligible revenue bonds. SIA tracked three major banks for 1981 and found that in every one of the 24 mortgage bond issues in which one of them served as a manager that bank had offered a letter of credit or other credit enhancement: 24 out of 24. This was an amazing coincidence.[1]

SIA pointed out that banks had not been very successful in selling themselves as managers on an even competitive basis in earlier years when credit enhancements were not significant. However, particularly in times of high interest, the unique ability of banks to provide letters of credit gave them the unfair advantage of being able to offer to provide a letter of credit to obtain a place in a management group. SIA argued then that existing tying restrictions in the law were inadequate to deal with these unfair situations, because no large, sophisticated bank would be dumb enough to actually demand a *quid pro quo* in so many words, but the pressure and unfair advantage were nonetheless there.

Letter of credit (LOC) volume in 1980 was only $100 million, but grew to $4.7 billion in 1981. The letter of credit support spread to other revenue bond sectors and in 1984 letters of credit were found in 374 issues aggregating $13.9 billion.

SIA decided to track the same three banks again and did so for 1984. This time all bank-eligible revenue bond sectors were looked at and the findings were that the three banks supplied letters of credit in 28 of the 36 issues as to which they served as underwriting managers--78%. This is quite a record.

These results demonstrate that the LOC is an incredibly valuable and unique tool for a bank to use to get itself into a management group. This is true whether the bank is underwriting as well as providing the LOC or whether the underwriting is being done by an affiliated securities affiliate.

This is a very real example of unfair bank advantage that is growing in the bank-eligible revenue bond market today. Other banks are now doing the same thing in increasing numbers. A separate subsidiary above does not solve the problem. Prior legislation in this Committee failed to address the problem and statements that existing antitrust laws are sufficient to protect against tie-ins are just not well founded.

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[1] *Securities Activities of Depository Institutions: Hearings on S. 1720 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, February 12, 1982, 97 Cong., 2nd Sess. 438-466, 457-466, 138-139 (Comm. Print 97-47, 1982).

WRITTEN STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
BEFORE THE
SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

JANUARY 23, 1987

I am David Silver, president of the Investment Company Institute. The Institute is the national association of the American mutual fund industry. Its members include over 1,800 mutual funds with assets of about $690 billion, accounting for over 90% of total industry assets, and approximately 20 million shareholders. The Institute also represents the unit investment trust industry, with unit trust members representing over $100 billion of outstanding deposits, or over 90% of total industry deposits.

Introduction

We appreciate the opportunity to testify at these hearings. Since 1981, the Institute has expressed its basic philosophy to this Committee -- that the Glass-Steagall Act embodies principles that are still sound and relevant. That philosophy, however, is not inconsistent with the realization that the world changes and that our financial system and its regulatory framework should change with it. We recognize that recent events have provided new grist to those who argue that the fall of Glass-Steagall is imminent, and even essential. For example, the London financial markets recently were deregulated, in the celebrated "Big Bang." The London market, in which no Glass-Steagall-like barriers exist, is now being heralded as the wave of the future, and many are predicting the certain demise of New York as a financial center should the Glass-Steagall barriers remain in the U. S. Critics of Glass-Steagall also point to the perceived loss of market share by banks to other financial institutions, as well as recent actions by bank regulators and the courts, as additional nails in the coffin. However, these events provide no basis for any legislation without a careful analysis of whether, and the extent to which, they justify a new direction in historic national policies. And assuming that these occurrences justify the combination of banking and other financial industries, Congress must recognize that the Glass-Steagall problems cannot be dealt with adequately in legislation that takes a narrow approach.

Whatever the facts may be, and whatever the urgency for change, an essential predicate for legislation is that it seek to accommodate the historic national policies set forth in the Glass-Steagall Act, the Bank Holding Company Act and related national laws -- insuring the safety and soundness of our banking system; preventing the abuses and conflicts of interest that inevitably arise from the combination of commercial and investment banking; and guarding against the undue concentration of economic power.

In recent years a number of proposals have been advanced which would provide for a comprehensive restructuring of our financial services industry, while at the same time seeking to provide for a field of fair competition and public protection. Under one proposal, a diversified financial holding company could own subsidiaries engaged in all types of financial activities (including banking, securities and insurance activities) with each subsidiary subject to "functional regulation" by the appropriate regulatory authority.[1] This proposal has been criticized because by itself it could permit unsound inter-affiliate transactions, produce conflicts of interest and lead to excessive concentration of economic power. In order to meet these concerns, another proposal recently has been advanced which would require a bank in a financial services holding company to separate its deposit-taking activities and its commercial lending activities.[2] While these and other past legislative proposals may not be wholly perfected, they at least represent attempts to provide a comprehensive framework designed to satisfy fundamental public policy concerns.

We had hoped that at these hearings this Committee would concentrate on these and other comprehensive proposals. Instead the Committee apparently has before it only the same series of piecemeal changes advocated by the nation's giant banks. Under these latter proposals, bank holding companies would be permitted to engage in a variety of new securities activities, but the nation's largest securities firms would continue to be barred from entering the banking business. Such a one-way street is hardly a recipe for fair competition or for a healthy securities industry needed to help finance American business. Moreover, the bank-supported proposals fail to address the conflicts of interest which will arise from the reentry of banking organizations into the mainstream of the securities business, most notably from bank holding company sponsorship and underwriting of mutual funds. Finally, these piecemeal changes are likely to result in an increase in the concentration of economic power in the hands of a few giant banking organizations.

We would like to address each of the problems inherent in the banks' proposals. At the conclusion of our testimony, we will offer concrete suggestions for legislative change if Congress determines to repeal or modify the Glass-Steagall Act.

1. Impact of Expanded Bank Powers -- Unfair Competition

Under the banks' piecemeal proposals, banking organizations would be granted a series of new securities powers (i.e., the authority to sponsor and underwrite mutual funds and the authority to underwrite and deal in revenue bonds, commercial paper and mortgage-backed securities). If these proposals are enacted, the nation's giant bank holding companies would be permitted to engage in both banking activities and numerous securities activities. Yet the nation's largest securities firms would continue to be prohibited from entering the banking business, since they underwrite corporate stocks and bonds and Glass-Steagall's prohibitions against the combination of banking and the underwriting of corporate securities would remain in place. Thus, piecemeal repeal of Glass-Steagall is likely to result in a competitive situation slanted sharply in favor of large bank holding companies.

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[1] See, e.g., Statement of Dr. George W. McKinney, Virginia Bankers Professor of Bank Management at the McIntire School of Commerce, the University of Virginia, Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, December 18, 1986.

[2] Litan, "Taking the Dangers Out of Bank Deregulation", The Brookings Review, Vol. 4, No. 4, Fall 1986, at 3.

Moreover, even complete repeal of Glass-Steagall, unless accompanied by legislation permitting interstate banking, is likely to result in an unfair competitive situation.

The restrictions on geographic expansion contained in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act have perpetuated a well-developed, nationwide correspondent system of banks through which the largest banks distribute their products and services through smaller "country banks":

> Correspondent relationships with "country banks" provide [major banks] another captive market. Major banks offer their correspondents services such as check clearing, loan participations, lines of credit and investment advice in return for deposit balances. A natural allegiance to the respondents arises from this relationship....[3]

If the Glass-Steagall Act is modified to permit large banks to engage in new securities activities, they can be expected to utilize the correspondent system to distribute securities through their well-established relationships with local banks. In each community these securities activities will be linked to the banking services provided by local banks to their banking customers.

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[3] Mehle, "*Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition*", 26 Syracuse L. Rev. 1117, 1145 (1975).

Thus, modification of the Glass-Steagall Act to permit banks to engage in securities activities will give the large banks a major competitive advantage over traditional securities firms. This advantage will exist *even* if securities firms are permitted to exercise full banking powers in a single state since, as new entrants into the banking business, securities firms would be newcomers to the correspondent system which has grown in the protectionist shelter of the McFadden Act and the Douglas Amendment. This competitive disadvantage is best dealt with by permitting competition to flourish on an interstate basis, as well as in particular financial products.

Various witnesses and some members of the Committee have expressed extreme reluctance to permit interstate banking or to repeal completely the Glass-Steagall Act. However, some who express these views are also vigorous proponents of giving banks a number of securities powers. There is an inherently elusive logic in the proposition that a Dallas bank, a San Francisco bank or a Milwaukee bank should be able to offer a broad spectrum of banking and securities services, while the branch offices of regional and national securities firms down the block in the same city are barred from the banking business. If there is an economic calculus which says that this will lead to improved competition and a healthy securities industry, it would seem to be a well-kept secret.

2. Impact of Expanded Bank Powers -- the Threat to the Existing System of Equity Distribution and the Financing of American Business

Today, corporate securities of existing and new companies are distributed to the public through syndicates of broker-dealers which possess national or regional retail sales organizations. However, few if any of these firms can support these sales organizations with a narrow product line. Most offer a broad array of securities services and products and must do so to remain economically viable.

Should certain securities product lines become available to banks, it is likely that banks will become dominant factors in the marketplace. Thus, if banks are permitted to progressively enter mutual fund, revenue bond, commercial paper and mortgage-backed securities activities, the overall profitability of independent securities firms could, in tandem, progressively deteriorate, particularly when the nation's securities firms would still be prohibited from engaging in banking activities. The large branch office networks, which are involved in securities underwriting, could well come under pressure as the profitability of their overall business declines.

The question then arises whether an independent securities industry is necessary for the distribution of corporate securities. Certainly, the function of equity capital formation currently performed by securities firms must be performed by someone. Thus, it is most likely that as independent securities firms become weaker, the remainder of the Glass-Steagall Act would be repealed to permit banks to assume the function of securities underwriting. Not only would this repeat the unwholesome situation of the 1920s, but it raises other important questions as to whether such a system is effective and desirable. It is clear that an independent securities industry in this country has been more willing to raise capital for small and innovative businesses than, for example, banks in countries where Glass-Steagall barriers have been eliminated.[4] Whether this would be true in the United States may or may not prove to the the case. In any event, it is this type of question which should be carefully explored before embarking on piecemeal legislative changes which are likely to be destructive of the American securities business as it exists today.

3. Impact of Bank Entry into the Mutual Fund Business -- Reemergence of Abuses

Proponents of bank entry into the mutual fund business usually argue that the abuses of the 1920s were restricted to

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[4] Last year the Director of the Capital Markets Department of the International Finance Corporation stated:

> "Experience shows that while [the dismantling of Glass-Steagall barriers] may be a "plus" for financial efficiency within and between the various subdivisions of the banking system, it can result in a weakening of the equity markets as the banking system as a whole tends to gain at its expense."

"Furthering Securities Market Development," Address of David Gill, Director, Capital Markets Dept., International Finance Corp., to the Eleventh Annual Conference of the International Association of Securities Commissions and Similar Organizations, Paris, France, July, 1986, p.p. 4-5.

bank underwriting of corporate stocks and bonds and that the abuses did not involve bank operation of mutual funds. Therefore proponents of expanded bank powers urge that the banking industry be given mutual fund authority without further study. They argue that it would be wholly prudent to permit bank holding companies to sponsor mutual funds and distribute their shares to the public, while continuing the Glass-Steagall bar on other forms of securities underwriting by banks.

History contradicts all these claims. The only justification for granting banks authority to enter the mutual fund business, while denying them other broad authority they seek, would lie not in logic but in expediency.

First, banks were heavily involved in the mutual fund business in the 1920s,[5] and there were widespread abuses in the operation of the bank-sponsored funds (then known as "investment trusts"). Second, these abuses took place regardless of whether the fund was sponsored by the bank or by a separate affiliate. Indeed, the pool of "other people's money", which is the essence of a mutual fund, is more susceptible to managerial conflicts than merely distributing the securities of a third party to the public as an underwriter.

Many of the widespread abuses stemmed from the bank's role as a commercial lender. The abuses included fund investment in debentures of a troubled company which was financed by the bank;[6] fund purchases of illiquid loans from the bank;[7] and fund loans to accommodate "good customers" of the bank.[8] In addition, there were instances in which the fund had invested in companies in order to further the bank's commercial interests --for example, fund purchases of stock in other banks in anticipation of statewide branching;[9] and so that the affiliated bank would be in a better position to sell correspondent services to these smaller banks.[10] Other abuses included fund investment in stock of the bank;[11] fund loans to the bank,[12] its securities affiliate,[13] bank officers and directors,[14] and companies controlled by insiders;[15] fund purchases of securities from the bank or its securities affiliate;[16] fund investment in companies in which insiders had an interest;[17] and fund purchases of securities being underwritten by the bank's securities affiliate.[18]

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[5] "The new era banker felt he must rescue the people by encouraging them to come to the bank for investment advice. The small investor was told that he should share the opportunity to grow rich with America, by putting his money in investment trusts. In order to facilitate this new service many large banks organized investment trusts of their own...." James Gerald Smith, Facing the Facts, 157 (1932).

[6] Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission Pursuant to Section 30 of the Public Utility Holding Company Act of 1935 (1939-1940), Pt. 3 at 127 (hereinafter cited as "Investment Trusts Study").

[7] Ibid at 150-51.

[8] Ibid at 2658 n. 44.

[9] Ibid at 167. Also see Pt. 4 at 159-160.

[10] Ibid at 167.

[11] Ibid at 131 and 162.

[12] Ibid at 149.

[13] Ibid at 130, 149 and 157.

[14] Ibid at 2655 and 2660-61.

[15] Ibid at 132-33 and 2716.

[16] Ibid at 130, 149 and 150.

A 1931 Report of a Subcommittee of the Senate Banking Committee stated the following concerning investment trusts (mutual funds) sponsored by banks:

> Activities of a bank's security affiliate as a holding or finance company or an investment trust are also fraught with the danger of large losses during a deflation period. Bank affiliates of this kind show a much greater tendency to operate with borrowed funds than do organizations of this type which are independent of banks, the reason being that the identity of control and management which prevails between the bank and its affiliate tends to encourage reliance upon the lending facilities of the former.
>
> In fact the mere existence of an affiliate which might be made the receptacle for unwise loans and investments when needed tends to reduce the degree of caution exercised by bank managements, there is reason to believe.[19]

Indeed, following the debacle of the 1920s, bankers themselves testified that the problems associated with bank affiliate

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[17] *Ibid* at 133 and 2716.

[18] *Ibid* at 134.

[19] Operation of the National and Federal Reserve Banking Systems, Hearings Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess., Pt. VII, at 1059-60 (1931).

sponsorship of investment companies were so great that these activities should be totally prohibited in the future.[20]

Thus it is clear that the bank abuses of the 1920s involved bank operation of mutual funds and that these abuses took place regardless of whether the fund was sponsored by the bank or by a separate affiliate of the bank. Therefore, it was not surprising that in 1971 the Supreme Court held in Investment Company Institute v. Camp[21] that the abuses which gave rise to the enact-ment of the Glass-Steagall Act are inherent in bank sponsorship of mutual funds. The Court found that "the potential hazards and abuses that flow from a bank's entry into the mutual investment business are the same basic hazards and abuses that Congress intended to eliminate almost 40 years ago...." The Court identified at least eleven specific dangers:

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[20] See, e.g., Investment Trusts Study, testimony of the Chairman of Chatham Phenix National Bank and Trust Company of New York, at 136:

> My experience was that if I was doing it today, I wouldn't do it at all, and I would never have formed the corporation, but this is hindsight, that is an after point of view....*I think that the whole theory of affiliated investment companies with banks was a mistake, especially when it was a distributing corporation*. (emphasis added)

and testimony of the President of Central Trust Company of Illinois, *Ibid* at 179:

> [Concerning] my philosophy of what a commercial bank should confine itself to in the way of financial service....As far as the relationship with an investment trust is concerned, particularly where that trust...has outside shareholders, even though the formation of the company made it very apparent that its operations were to be administered by the same officers that administered the [bank and its securities affiliate], nevertheless any conscientious officer will try to administer each of those three companies for its own best interest. As long as your security market is stable or inclining upward, as long as you are in a period of reasonable prosperity, I feel that that sort of relationship is endurable. But, once the reverse takes place, then your officers are in constant embarrassment.

Also see the conclusion of the Counsel to the SEC Study on Investment Trusts and Investment Companies:

> I think there is nothing so clear as the fact that this relationship between the banks and the investment companies has proved unfortunate. The president of the Liberty Bank said that there ought to be absolute segregation. The head of the M. & T. Bank said the same thing. The head of the Central Illinois said that the relationship was unsatisfactory. I do not think there is any question about it as far as our record is concerned. Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 73d Cong., 3d Sess. 885 (1940).

- "the bank and the [securities] affiliate are closely associated in the public mind, and should the associate fare badly, public confidence in the bank might be impaired";
- "since public confidence is essential to the solvency of a bank, there might exist a natural temptation to shore up the affiliate through unsound loans or other aid";
- "the bank would make its credit facilities more freely available to those companies in whose stock or securities the affiliate has invested";
- "banks might even go so far as to make unsound loans to such companies";
- "bank depositors might suffer losses on investments that they purchased in reliance on the relationship between the bank and its [securities] affiliate. This loss of customer good will might 'become an important handicap to a bank during a major period of security market deflation'";
- "banks...might be tempted to make loans to customers with the expectation that the loan would facilitate the purchase of stocks and securities";
- "security affiliates might be driven to unload excessive holdings through the trust department of the sponsor bank";
- "the bank would have a salesman's stake in the performance of the fund, for if the fund were less successful than the competition the bank would lose business and the resulting fees";
- "the bank might exploit its confidential relationship with its commercial and industrial creditors for the benefit of the fund";
- "the bank might undertake, directly or indirectly, to make its credit facilities available to the fund or to render other aid to the fund inconsistent with the best interests of the bank's depositors";
- "the bank might divert talent and resources from its commercial banking operation to the promotion of the fund."

4. Bank Sponsorship of Mutual Funds -- Inadequacy of Previous Legislative Proposals to Address Conflicts of Interest

Proponents of the reentry of banks into the mutual fund business argue that the use of separate affiliates and application of the existing federal banking and securities laws will prevent a recurrence of the abuses of the 1920s.

However, it is well-recognized that reliance on an affiliate system between a banking organization and its securities component will not work without other appropriate safeguards. Chairman Volcker and the FDIC have told Congress that the fortunes of a bank cannot be separated from its affiliates. In fact, former Citicorp Chairman Walter Wriston has stated: "Lawyers can say you have separation but the marketplace is persuasive and it would not see it that way."[22]

We agree. Separate affiliates by themselves did not provide protection in the 1920s or when bank-affiliated REITs got into trouble in the 1970s. There is no reason to believe that they will provide such protection today.

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[21] 401 U.S. 617 (1971).

[22] Hearings on S. 1686, S. 1703, S. 1720 and S. 1721 Before the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess., pt. 2, at 589-90 (1981).

In addition, application of the existing federal banking laws to proposed bank mutual fund activities will not address the issues of public protection. As first recognized by former SEC Chairman William Cary in 1963:

> The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection.[23]

Also insufficient is the application of existing securities laws to proposed bank securities activities as recognized by SEC Chairman Shad, Chairman Volcker,[24] and the North American Securities Administrators Association.[25] Congress enacted these laws on the assumption that the Glass-Steagall Act prohibited commercial banks from engaging in the securities business. Therefore, while the securities laws address specific problems that arise when investment banking firms, broker-dealers and investment advisers engage in securities activities, they are totally silent with respect to the unique problems presented by the securities activities of commercial banks.

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[23] Testimony of William Cary before the Senate Subcommittee of the Committee on Banking and Currency, SEC Legislation 1963: Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 88th Cong., 1st Sess., 20 (1963).

[24] Hearings on S. 1686, S. 1703 and S. 1721 before the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess., pt. 2 at 466, 914 (1981).

[25] Hearings on S. 2181 and 2134 before the Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 2d. Sess., pt. 2 at 943-44 (1981).

For example, the Investment Company Act was enacted by Congress to deal with the unique and specific conflicts that arise when investment banking firms, brokerage firms and investment advisers sponsor, manage and distribute the shares of mutual funds. However, because Congress believed that it had successfully excluded banks from the mutual fund business, the Act does not purport to deal with the unique conflicts of interest that result when commercial banks or their affiliates engage in the mutual fund business. As SEC Chairman Shad has testified:

> ...[t]he Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Therefore, the Investment Company Act could not address the problem of bank conflicts of interest specifically.[26]

In short, if bank holding companies are to be permitted to organize, sponsor and distribute the shares of mutual funds, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest that will result. But the legislative changes proposed by the banks are totally silent in this area.

5. Bank Entry into the Mutual Fund Industry -- Concentration of Economic Power

As bank witnesses have testified before this Committee, certain bank trust department activities are quite similar to mutual funds -- indeed similar enough, it is argued, to justify bank expansion into the mutual fund business. We would agree with the assertion of similarity, but we draw far different conclusions.[27]

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[26] Statement of SEC Chairman John S.R. Shad, Hearings on S. 1686, S. 1703, and S. 1721 Before the Senate Committee on Banking, Housing and Urban Affairs, Part II, 97th Cong., 1st Sess. at 914 (1981).

Banks have already used their preferred regulatory position as commercial lenders to enhance their competitive position as investment managers. Much of the bank holdings of securities arise from bank management of corporate retirement plans. It is well-known throughout the pension industry that corporations historically have selected banks as managers of their retirement plans to enhance the corporation's relationship with the commercial side of the bank, despite inferior investment performance.[28] Indeed, Section 106(b) of the Bank Holding Company Act expressly permits banks to tie loans to the customer's purchase of trust services. Thus, banks clearly use the leverage they gain from being commercial lenders to enhance their standing in a very different business -- investment management. Whether one labels such enhancement as tie-ins or "bundling," the latest euphemism coined by the bankers, it is equally unfair competition.

Proposals to expand bank powers to permit them to sponsor and mass-merchandise mutual funds would give rise to the potential for increased tie-ins and "bundling". Aside from the fact that such expansion can have a devastating competitive effect on the mutual fund industry -- both on those who manage mutual funds and those who sell them -- there are other public policy implications. The domination of yet another form of the investment business can place a handful of large banks in effective control of even the largest companies in America.

Bank entry into the mutual fund business would greatly increase the equity holdings of the banking sector. Over the long run, concentration would increase because banks would steadily build equity portfolios in tandem with their control over the investment policies of equity mutual funds. Initially, however, these equity holdings would expand sharply as large banking institutions move quickly to acquire large mutual fund advisory organizations.

In 1984, the Institute undertook a study of the results that would occur if the top 20 bank holders of equity securities were to acquire the top 20 mutual fund advisory organizations (using portfolio values that prevailed in mid-1983). The study demonstrated that these acquisitions would dramatically balloon

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[27] For example, we agree with SEC Chairman Shad that all collective investment vehicles managed by banks, including bank common trust funds and collective investment funds for retirement plans, should be carried out within separate affiliates and made subject to SEC regulation. See Statement of SEC Chairman John S.R. Shad, Oversight Hearings on the Financial Services Industry Before the Senate Committee on Banking, Housing and Urban Affairs, Part II, 98th Cong., 1st Sess. at 372-75 (1983).

Indeed, we believe that "investment management, including trust activities, is basically a securities activity" and therefore any restructuring of financial regulation should harmonize trust department and mutual fund regulations. See Statement of Dr. George W. McKinney, Virginia Bankers Professor of Bank Management at the University of Virginia, Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, December 18, 1986, at 24.

[28] See, e.g., Editorial, "Investing Solely in Interest of Beneficiaries," Pensions & Investments, January 1, 1979, at 6.

The **Chairman**. Thank you very much, Mr. Silver.

Mr. Irons.

STATEMENT OF WILLIAM V. IRONS, CHAIRMAN, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS FINANCIAL INSTITUTIONS TASK FORCE

Mr. **Irons**. Mr. Chairman, before I begin my remarks, I would like to thank the junior Senator from Rhode Island, Senator Chafee for his very kind comments. I would be remiss, however, if I didn't correct one point he made. I am a deputy majority leader in our State senate, where our party is the majority. [Laughter.]

The **Chairman**. I'm not sure. Your party is the Democratic Party.

Mr. **Irons**. Without question, Mr. Chairman. [Laughter.]

That's what I meant, "our party," meaning you and I.

The **Chairman**. I thought there was something very compelling about you. [Laughter.]

Go right ahead.

Mr. **Irons**. Thank you.

Mr. Chairman, my name is William V. Irons. I am a life underwriter from East Providence, RI, and chairman of the National Association of Life Underwriters Financial Institutions task force. I also serve as a Democratic senator in the Rhode Island State Legislature.

I am speaking today on behalf of a coalition of insurance agent groups. Together these associations represent most of the life/health/property/casualty, personal, and commercial lines agents and brokers in this country.

Mr. Chairman, we completely share the view expressed by you and other members of this committee that the 100th Congress will represent a marked departure from the legislative stalemate of the recent past during which Congress failed to enact legislation closing the South Dakota and nonbank bank loopholes.

INSURANCE ACTIVITIES

New legislation is needed now to affirm longstanding legislative goals. The policy concerns that persuaded Congress in 1982 to reaffirm the limits on bank holding company insurance activities in title VI of the Garn-St Germain Act remain equally valid today. In 1982, Congress recognized the anticompetitive effects implicit in banks' control of credit. More often than not, we believe consumers purchase insurance from banks to protect their source of credit, not because insurance is available at lower prices, definitely not because of better product or service.

Insurance sales are particularly vulnerable to direct or implied coercion. Insurance is usually required for a borrower to qualify for credit.

In the current clamor for expanded bank insurance powers, bankers maintain that by offering such services, they will enhance competition and serve the best interest of the consumer. That contention cannot survive close scrutiny.

In testimony in 1984, our coalition submitted to this committee our comments to the Federal Reserve Board regarding the banks' record on credit-related insurance. That submission comprehensively set forth the banks' record of overcharging on credit-related insurance and coercing borrowers to purchase credit insurance.

In that regard, Mr. Chairman, the previous speaker talked about a 50-percent penetration. Litigation in Missouri has proven a penetration rate of over 90 percent in most instances.

Over the past 4 years, we have witnessed large bank holding companies aggressively seeking to circumvent restrictions on insurance activities contained in the Bank Holding Company Act through the use of State-chartered bank subsidiaries in South Dakota, Arizona, and most recently, in the District of Columbia. Nor has the Comptroller of the Currency stood by idly. Rather than heed the banking laws as passed by Congress, the Comptroller has taken highly controversial actions to confer new nonbanking powers upon the institutions he regulates. During this administration the Comptroller of the Currency has yet to meet a power for banks he did not like.

The most egregious example of attempted overreaching arose when Citicorp attempted to acquire a South Dakota bank in order to engage in general insurance sales. It promoted this alleged loophole by arguing that title VI only applies to nonbanking subsidiaries of a bank holding company. In other words, Citicorp argues that Congress intended to permit banking subsidiaries to sell insurance while simultaneously prohibiting nonbanking subsidiaries from engaging in precisely the same activity. Citicorp's contention is nonsensical.

All of the groups I speak on behalf of today support the so-called Dodd amendment which is needed to end debate over the possible existence of the State bank loophole. The Dodd language which was passed by the Senate in 1984 clarifies the scope of title VI for those who need clarification.

It is true, as this committee knows, that the Federal Reserve Board ultimately denied Citicorp's South Dakota application, but the threat to exploit State laws to circumvent insurance restrictions in the Bank Holding Company Act continues. Within the past month, we learned that the Comptroller has granted preliminary approval for the establishment of 10 new banks in the District of Columbia. These approvals will again raise the issue of whether bank subsidiaries of bank holding companies can invest the bank holding company with insurance authority prohibited to it under the Bank Holding Company Act.

The attempt by Federal regulators to ignore congressional intent has found other outlets as well. In August 1986, the Comptroller of the Currency gave permission to the United States Bank of Oregon to sell insurance to consumers located anywhere in the United States, merely because it had a branch in a town of under 5,000 people. This unprecedented decision permits national banks to use small towns as launching pads for gigantic insurance efforts. The Comptroller has thus transformed the small town exemption designed to permit general insurance activities by banks in towns of less than 5,000 into a vehicle for banks to engage in general insurance agency activities on a nationalwide basis in violation of the insurance restrictions in the National Bank Act and the BHC Act.

In conclusion, Mr. Chairman, we do not seek protection. We seek only fair competition. Wholesale entry by banks into the insurance business will create no new capital source, no new jobs, no new services. The bankers themselves neither pretend to be better sales people nor claim to have better insurance products or services to offer, better prices or to be more available; however, they know that they can get the insurance business because of the credit relationship. If they succeed on this basis, neither the public nor the insurance industry will well be served.

I'll be happy to answer your questions.

[The complete prepared statement of William Irons follows:]

bank concentration of holdings of the stock issues of individual companies and industries.[29] To our knowledge, no proponent of expanded bank powers, nor any Congressional committee or federal agency, has studied the likely economic impact of bank entry into the mutual fund business using current data. We submit that it would be most unwise for the Congress to grant banks mutual fund powers without the benefit of a comprehensive examination of the concentration issue based on current data.

The expansion of the banking sector's holdings through acquisitions of mutual fund advisory organizations, moreover, is only the first step. Bank equity holdings would continue to grow

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[29] The following table sets forth the results of that study:

BANK CONCENTRATION--BEFORE AND AFTER
VALUE OF BANK HOLDINGS OF EQUITIES AS A PERCENT
OF TOTAL AMOUNT OUTSTANDING:

COMPANY	TOP 20 BANK TRUST DEPARTMENTS	AFTER TOP 20 BANK ACQUISITIONS OF TOP 20 MUTUAL FUND ADVISORY ORGANIZATIONS
IBM	12.3%	18.5%
AT&T	4.7	8.3
GENERAL ELECTRIC	10.6	15.8
STANDARD OIL, CALIF.	19.0	21.4
EXXON	7.8	9.3
GENERAL MOTORS	7.9	11.4
SCHLUMBERGER LTD.	8.3	13.3
INDUSTRY		
AUTO PARTS	15.8%	22.3%
HOTEL-MOTEL	14.2	20.7
TRUCKERS	12.9	25.2
PUBLISHING	12.4	23.8
AIR FREIGHT	10.3	22.3

over the longer term -- along with concentration and potential conflicts -- as investors channeled dollars into newly created bank equity mutual funds.

The existing concentration of investment management and equity holdings in a few banks might in itself give pause to yet further expansion of bank authority in this area. However, the failure to assure competitive equity makes it certain that the winds of change will blow in one direction. As a result of the special privileges conferred on banks by government, the financial services industry in this country will be centered around a few giant banking organizations. All large banks need do, after the observance of a few legal niceties, is to hang out a shingle announcing that they are in the mutual fund business, and increased concentration of both equity holdings and financial services will inevitably follow.

The tendency towards concentration inherent in the banks' proposed legislative changes will not be subject to any significant countervailing competitive pressures. The nation's largest securities firms would not be allowed to enter the banking business since these firms engage in the underwriting of corporate securities. But even if those firms abandoned underwriting in order to engage in banking, the geographical protectionism in the banking laws would sharply limit their competitive force. The largest companies in the securities industry are national in scope. They distribute their financial products nationwide and cannot accommodate their distribution channels to the geographical restrictions imposed on banking. The competitive strengths of the nation's major securities firms cannot be brought to bear in the banking industry while these restrictions remain in effect. Bank witnesses have eagerly endorsed proposals granting banks expanded powers. With all due respect, we would suggest that their enthusiasm would be tempered if legislation provided for truly fair competition whereby the local securities sales offices could offer banking services while they offered mutual fund products.

In short, the previous legislative proposals considered by this Committee and supported by the banks act unwittingly as a tremendous engine for the concentration of financial services and equity holdings in banks. Their fundamental failure is their narrow focus on the issue of bank powers without any examination of the effect on competitors of the banking industry. Such an examination would reveal that, as the banking industry is now structured and protected, it is inevitable that the end result of the process set in motion by the enactment of such legislation will be a concentration of financial power to a degree that the nation has never seen.

6. A Program for the Future

The Institute has considered the many problems raised by the legislative proposals thus far considered by the Committee and has offered specific legislative solutions in the mutual fund area. As early as 1983, we discussed our concerns with then Deputy Treasury Secretary McNamara and his staff and, at his

invitation, submitted a detailed memorandum identifying major deficiencies in the Treasury bill and a series of specific amendments designed to remedy them.

We believe that our suggestions are not only soundly based on principle, but also contemplate a realistic framework for the future. If indeed the Glass-Steagall Act is to be substantially repealed or modified, we have urged seven points for legislative attention. Let me summarize them:

(1) All bank securities activities should be conducted in separate holding company affiliates;

(2) Banks and their securities affiliates should be strictly regulated to assure their legal and functional separation;

(3) All new securities activities of bank affiliates should be subject to SEC regulation;

(4) All present bank securities activities should likewise be subject to SEC regulation;

(5) The securities laws should be amended to deal with the special problems arising when affiliates of commercial banks engage in retail securities activities;

(6) The securities and banking laws should be modified to provide for a flexible regulatory framework for all collective investment funds so as to provide common regulation for like products; and

(7) Restrictions on entry into banking and geographic limitations should be eased so that securities firms and banking

organizations can compete on an equal basis throughout the nation.

This program is admittedly far-ranging and complex. Its implementation would require hard work, careful study and a spirit of compromise.

Thus far, however, our proposals have been ignored by most proponents of expanded bank powers. They refuse to see that ending the long legal cleavage between commercial and investment banking would require ending the wide disparities which now exist between banking and securities regulation. This is unfortunate since our proposals in this regard are not based on abstract theory but on an historical record of grave abuse and marketplace realities. Legislation devoid of provisions to control the inherent conflicts of interest between commercial and investment banking activities is simply a recipe for the repetition of financial disasters, disasters which marked the culmination of previous experiments which permitted banks to mass-merchandise securities. Moreover, one-sided legislation favoring banks would be damaging to the securities industry and to capital formation.

In 1984, a bipartisan majority of this Committee specifically rejected providing commercial banks with mutual fund powers. We do not believe that anything has happened since to undermine this conclusion. Nonetheless, we are hopeful that we can make a contribution to a long-term resolution of the legislative issues involved in the restructuring of the financial

services industry. The continuing controversy unsettles our financial marketplace, diverts business planning into an irrational search for "loopholes" and robs our legal and business institutions of public credibility.

The issues we have raised are important and we have presented them to you in all good faith. We hope that the Committee and the banking industry will give them the serious consideration they need. If Congress is going to make fundamental changes in the basic structure of the financial services industry, a structure which has served this nation so well for the past fifty years, then careful preparation is required so as to lay the groundwork for another fifty years of growth and prosperity.

Testimony of the

INSURANCE AGENT COALITION*

by

William V. Irons, CLU
Chairman
Financial Institutions Task Force

of The National Association of
Life Underwriters

Presented before the

Committee on Banking, Housing
and Urban Affairs

United States Senate

January 23, 1987

*Insurance Agent Coalition:

Independent Insurance Agents of America
National Association of Casualty and Surety Agents
National Association of Insurance Brokers
National Association of Life Underwriters
National Association of Professional Insurance Agents
National Association of Surety Bond Producers

Mr. Chairman, my name is William V. Irons. I am a life insurance agent from East Providence, Rhode Island and Chairman of The National Association of Life Underwriters' Financial Institutions Task Force. I also serve as a senator in the Rhode Island State Legislature.

I am speaking today on behalf of a coalition of insurance agent groups--a coalition that includes The National Association of Life Underwriters, The Independent Insurance Agents of America, The National Association of Professional Insurance Agents, The National Association of Casualty and Surety Agents, The National Association of Insurance Brokers, and The National Association of Surety Bond Producers. Together these associations represent most of the life/health, property/casualty, personal and commercial lines agents and brokers in the country.

Mr. Chairman, we completely share the view expressed by you and other members of this Committee that the 100th Congress will represent a marked departure from the legislative stalemate of the recent past during which Congress failed to enact legislation closing the South Dakota and non-bank bank loopholes.

New legislation is needed now to affirm long-standing legislative goals. The policy concerns that persuaded Congress in 1982 to reaffirm the limits on bank holding company insurance activities in Title VI of the Garn-St Germain Depository Institutions Act remain equally valid today. In 1982 Congress acted for both historical and practical reasons. Historically, the separation between banking and commerce has for 50 years proscribed most banking institutions' authority to engage in insurance activities. The Garn-St Germain Act extended to bank holding companies the insurance restrictions that historically have applied to all national and most state banks. Congress thus demonstrated that bank holding companies are themselves banking institutions where insurance activities must be strictly and stringently limited in order to guard the public interest.

The historical theme is grounded in common-sense recognition of the practicalities of the marketplace. In 1982 Congress recognized the anti-competitive effects implicit in banks' control of credit. The combination of credit and insurance, Congress found, both constricts the consumer's ability to choose insurance free from the influence of credit, and permits unfair competition by banks against other sellers in the market who have no power to extend or withhold credit.

Whether direct or implied, the results of the credit tie-in are the same; more often than not we believe consumers purchase insurance from banks to protect their source of credit, not because insurance is available at lower prices or with better product or service. Banks, too, due to banking services and credit, have a captive consumer market. In the meantime, the rest of the insurance market is fenced away by the insurmountable and unfair competitive barrier of banks' control of credit. Hence the anomaly that bank insurance sales actually choke off competition rather than generate it. Competition never has a chance to function when one competitor holds a unique advantage over the rest of the field.

More to the point, insurance sales are particularly vulnerable to direct or implied coercion. Unlike most other services a bank may offer, insurance is usually required for a borrower to qualify for credit, and insurance coverages are almost always certified at the point of the loan transaction.

The **Chairman**. Thank you very much, Mr. Irons.
Mr. Hughes.

STATEMENT OF GARY HUGHES, CHIEF COUNSEL, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. **Hughes**. Thank you, Mr. Chairman. As you noted, I am filling in today for Bob Googins of Connecticut Mutual Life Insurance Co., and I am sure he sends his regrets for not being here from somewhere between Washington and Hartford.

Incidentally, if you show the same determination in passing a banking bill as you have had in having these hearings, despite the weather, I am sure we are going to have legislation in 1987. [Laughter.]

The **Chairman**. Thank you.

Mr. **Hughes**. We are principally concerned with three of the issues before the committee, the issue of expanded powers, the issue of the South Dakota or State bank loophole, and the nonbank bank loophole.

As I suspect you may be aware, the issue of greatest concern to us is the State bank loophole. In the past, there's been a great deal of confusion over what this loophole involves, but I think it can be reduced to a single question. Should bank holding companies be permitted to avoid the restrictions on nonbanking activities contained in the Bank Holding Company Act by putting those activities in a State bank subsidiary of a bank holding company?

We think that the answer to that question is an obvious no. Otherwise, the Bank Holding Company Act is a rather meaningless statute and we don't believe the proper operation or interpretation of the dual banking system is supposed to render Federal statute meaningless.

SENATOR DODD'S SOLUTION IS THE SIMPLEST

Senator Dodd's solution to the State bank loophole, which has been mentioned, remains the simplest and most effective way to deal with this issue. The Dodd language, contrary to testimony which you've heard from bankers, is in no way an infringement on States' rights. It does not apply to unaffiliated or freestanding banks, that is, banks that are not part of a federally regulated bank holding company system. It does not preempt the right of any State to pass whatever laws it deems appropriate or to invest its institutions with whatever powers deemed appropriate. It does not preempt any State law, even South Dakota's

What it does do, and we believe for good reason, is to differentiate between freestanding banks and those that are part of a holding company system. For the most part, State banks are not forced to become associated with bank holding companies. Rather, they elect to form bank holding companies or to be held in holding company form, subject to the Bank Holding Company Act, for the purposes of obtaining some benefits, such as tax advantages over freestanding banks or for the avoidance of State branching limitations.

By electing to take advantage of the benefits of the Bank Holding Company Act, these entities must also be prepared to accept the act's restrictions, one of which is a general prohibition on insurance activities.

We also believe that closing the State bank loophole is even more important today, in view of congressional action which may result in the closure or substantial limitation of the nonbank bank loophole. The nonbank bank and State enabling legislation loopholes are flip sides of the same coin. Nonbank banks enable insurers and other nonbanking entities to enter the banking business, and the State bank loophole enables bank holding companies to enter the insurance and other nonbanking businesses otherwise prohibited to them under the Bank Holding Company Act.

We do support closing the nonbank bank loophole, but only if the State bank loophole is closed at the same time. Otherwise, given the highly competitive financial services marketplace, we believe that closing one loophole and not the other would create, over time, severe competitive inequities.

I would just add that the language we propose to close the State bank loophole would also remedy abuses in the insurance area that may result as part of the so-called DC loophole.

Our written statement discusses a number of erroneous arguments which we've heard for allowing banks to enter the insurance business. I won't go into all of them, but I would like to touch on two.

ENCROACHMENT MYTH

The first is the so-called encroachment myth. That is, the notion that banks traditional activities are being eroded by competition from nonbank financial service providers. The statement of the American Bankers Association laying out this argument makes no mention of the extent to which banks are engaged in traditional insurance activities. I suggest to you that a fair comparison would show that bankers have invaded insurance territory to a far greater degree than insurers have invaded banking areas.

The second point is the myth which involves bankers' claims that their entry into insurance would solve the liability insurance crisis and save consumers billions of dollars annually in insurance costs. The fact is that banks have no intention of entering the commercial liability insurance market and have said so in as many words. Their real interest is profits, in particular, skimming what they perceive as some of the low risk cream off the insurance business and leaving the rest to insurers. The liability insurance crisis is merely an excuse to open the door initially.

The claims you've heard from bankers as recently as yesterday concerning what they could save consumers annually in insurance costs, if permitted to enter the business, are simply incorrect. The many unreasonable assumptions that underlie those claims demonstrate the banks' lack of understanding of the insurance market and its products. The claims sound impressive, but they have no basis in fact.

[The complete prepared statement follows:]

Most people instinctively grasp the validity of the credit tie-in argument, but for skeptics there exists a large body of academic studies, court findings, and congressional and agency reports that establish the anticompetitive effects of credit tying on both insurance agents and consumers.

In the current clamor for expanded bank insurance powers, bankers maintain that by offering such services they will enhance competition and serve the best interest of the consumer. That contention cannot survive close scrutiny.

In testimony on March 6, 1984, our coalition submitted to this Committee our comments to the Federal Reserve Board regarding the banks' record on credit-related insurance. That submission comprehensively set forth the banks' record of overcharging on credit-related insurance and coercing borrowers to purchase credit insurance. We concluded that:

> "...rapacious overcharging, failure to return unearned premiums when loans are paid off or the borrower dies during the term of the loan, failure to notify survivors of borrowers that loans have been paid off by credit insurance, and tying sales of credit insurance to extensions of credit have all been common practices in connection with credit insurance sales."

That conclusion is not ours alone. Former Tennessee Insurance Commissioner John C. Neff, who also served as the Chairman of the National Association of Insurance Commissioners' Credit Insurance Task Force, made the following observation in his comments filed in 1984 with the Federal Reserve Board:

> "...the business of credit insurance in the United States is a national scandal. I know of no other product where the public is so blatantly abused by what are supposed to be responsible financial institutions...Every insurance commissioner in the United States has struggled valiantly to try to lower the price of this insurance to a fair level in the face of tremendous opposition by banks and other creditors... If there is a single reason why the various insurance commissioners are opposed to the banking industry entering the business of the sale and underwriting of insurance, it is credit life insurance. Every bank that I know of sells credit insurance at the maximum price allowed by law and makes no attempt to sell it at a price that would produce a fair return of benefits to consumers."

Commissioner Neff further indicated, on the basis of preliminary data gathered on a national basis for 1982, that "consumers are being overcharged by approximately $650,000,000," and he noted that this figure appeared to be a substantial understatement. And, in an earlier era, the Comptroller of the Currency also recognized the threat of coercion in the sale of insurance by banks. In 1979 the Comptroller's staff submitted comments to this Committee in which it analyzed data showing that more than 35% of consumers who purchased credit insurance from a bank felt considerable pressure from the bank to do so. The Comptroller's staff concluded that "if 35.9% of borrowers who took credit insurance felt significant sales pressure, it is hard to reach the conclusion that joint sales of credit and credit insurance did not involve some type of explicit coercion."

In the face of the threats of decreased competition, credit tie-ins, conflicts of interest and concentration of economic power, Congress must take prompt action to maintain the integrity of its carefully crafted regulatory scheme. Over the past four years we have witnessed large bank holding companies aggressively seeking to circumvent restrictions on their insurance activities contained in the Bank Holding Company Act through the use of state-chartered bank subsidiaries in South Dakota, Arizona and, most recently, in the District of Columbia. Nor has the Comptroller of the Currency stood by idly. Rather than heed the banking laws as passed by Congress, the Comptroller has taken highly controversial actions to confer new non-banking powers upon the institutions he regulates. During this administration the Comptroller of the Currency has yet to meet a power for banks he did not like.

Insurance agents, of course, realize that banking reforms are being proposed in a financial market context marked by extraordinary change. Technological innovations, the growth and success of non-depository financial institutions, mergers and acquisitions, and a bewildering array of financial service hybrids all undeniably have influenced the way financial services are organized, marketed and regulated. But at least two things must be said to put these market changes and proposed restructuring into perspective.

First, while much has changed about banking over the past few years, one fundamental principle remains constant. Safety and soundness, the separation of banking and commerce, and a recognition of the special power associated with providing our economy's credit continue to define the fundamental features of banking. We ignore those considerations at our peril.

Second, in the context of a federal system as unique and specialized as banking, it is not enough to look approvingly on the innovations of the marketplace or the legal ingenuity of our nation's largest banks. Congress must determine either that these changes are in the public's interest, or, if they are not, must set limits that are relevant to the day-to-day conduct of banking.

The most egregious example of attempted over-reaching arose when Citicorp attempted to acquire a South Dakota bank in order to engage in general insurance sales. It promoted this alleged loophole by arguing that Title VI only applies to non-banking subsidiaries of a bank holding company. In other words, Citicorp argues that Congress intended to permit banking subsidiaries to sell insurance while simultaneously prohibiting non-banking subsidiaries from engaging in precisely the same activity. Citicorp's contention is nonsensical.

Of course, Citicorp's argument does not apply to South Dakota alone. We face not just a "South Dakota" loophole but a much broader "state law" loophole that would allow any state to strip away the protections of the Act. The critical issue, therefore, is whether the prohibitions of Title VI apply to bank holding companies and all of their subsidiaries, bank and non-bank alike, no matter how the holding company is structured or where its subsidiaries are located.

The answer to this question is simple. Title VI applies to the entire holding company system. Were this otherwise, a bank holding company need only find a receptive general assembly, have a favorable law enacted, and use its state-chartered bank to engage in insurance and possibly other non-banking activities that are prohibited to it by Section 4(c)(8). We do not believe, however, that federal laws are subject to repeal by compliant state legislators. Indeed, no one, not even the most aggressive proponent of new powers, has suggested that state legislators should be able to repeal federal law as it applies to nonbanking subsidiaries of bank holding companies. To allow a different outcome for banking subsidiaries would make a mockery of Congress' authority which has been historically recognized to maintain the separation of banking from commerce.

All of the groups I speak on behalf of today support the so-called Dodd Amendment which is needed to end debate over the possible existence of the state bank loophole. The Dodd language, which was passed by the Senate in 1984, clarifies the scope of Title VI for those who need such clarification and explicitly informs bank holding companies that Title VI covers all of their subsidiaries, including state-chartered banks.

States' rights are not at issue here. The Dodd language does not change the right of any state to authorize insurance or other activities for the freestanding banks that they charter. Freestanding state banks, not affiliated with a bank holding company, would continue to exercise any powers deemed appropriate by the legislatures of their states.

Restrictions on state banks that affiliate with bank holding companies are, however, eminently fair. State banks become part of a holding company system to avoid restrictions on branching and to obtain tax advantages. When they elect to benefit from federal law, they also become subject to its restrictions. State banks cannot have it both ways. They cannot pick the provisions with which they wish to comply.

It is true that, as this Committee knows, the Federal Reserve Board ultimately denied Citicorp's South Dakota application. But the threat to exploit state laws to circumvent insurance restrictions in the Bank Holding Company Act continues. Within the past month we learned that the Comptroller of the Currency has granted preliminary approval for the establishment of 10 new banks in the District of Columbia. These approvals will again raise the issue of whether bank subsidiaries of bank holding companies can invest the bank holding company with insurance authority prohibited to it under the Bank Holding Company Act.

The attempt by federal regulators to ignore congressional intent has found other outlets as well. On August 18, 1986 the Comptroller of the Currency gave permission to the United States National Bank of Oregon to sell insurance to consumers located anywhere in the United States merely because it had a branch in a town of under 5,000 people.

As the Committee knows, the National Bank Act, 12 U.S.C. §24, prohibits a national bank from engaging in any activity that is not expressly authorized by law or that is not incidental to one or more of such expressly authorized activities. The National Bank Act, 12 U.S.C. §92, does, however, permit national banking associations "located and doing business in any place the population of which does not exceed five thousand inhabitants" to "act as the agent for any fire, life or other insurance company authorized by the authorities of the State in which such bank is located to do business in said State..." The Comptroller issued an unprecedented decision permitting national banks to use small towns as launching pads for gigantic insurance efforts. The Comptroller said:

> "...a national bank or its branch which is located in a place of 5,000 or under population may sell insurance to existing and potential customers located anywhere. In other words, while the bank or bank branch must be located in a small town, it can sell insurance to persons and businesses located outside that town."

As a result of the Approval, and the entry of national banking associations into the general insurance agency business, (i) U.S. Bank, and other national banking associations, would be selling insurance in places and through means that are not authorized by the National Bank Act, 12 U.S.C. §24 and §92 and (ii) U.S. Bank, and other national banking associations that are subsidiaries of bank holding companies, would be engaging in insurance agency activities in violation of Section 4(c)(8) of the Bank Holding Company Act of 1956, 12 U.S.C. §1843(c)(8).

The Comptroller has thus transformed the "small town" exemption designed to permit general insurance agency activities by banks in towns of 5,000 or less into a vehicle for banks to engage in general insurance agency activities on a nationwide basis in violation of the insurance restrictions in the National Bank Act and in the Bank Holding Company Act. As you might expect, we have filed legal action to overturn the Comptroller's action. But legislative action is needed as well to uphold the distinction between banking and insurance under both the National Bank Act and the Bank Holding Company Act.

Mr. Chairman, we do not seek protection; we seek only fair competition. Insurance today is highly competitive in terms of price, product and service. Numerous outlets, ease of entry, and opportunity to apply entrepreneurial skills to achieve economic success are the hallmarks of today's insurance market, and every day bring to customers the tangible, real-life benefits of competition.

More banks selling insurance will not mean more competition. In this country, banking is highly regulated and endowed uniquely with a government franchise to accept deposits, extend commercial credit, benefit from certain tax and interest rate advantages, and rely on the protection of federal deposit insurance. This, combined with banks' access to loan customers' privileged financial profiles and insurance records, gives banks an obvious and insurmountable competitive edge over insurance agents. Moreover, these unfair advantages place the consumer at the mercy of his credit requirements, forcing him to base a decision to purchase insurance on factors other than lower price or better service.

Insurance agents are independent-minded, small business people who operate in a fiercely competitive insurance market. We value our independence, and our ability to offer consumers the kind of continuing service and advice necessary to provide adequate protection for their life and health, personal property and commercial enterprises. The agent coalition urges this Committee to take a hard look at what the banks seek and why they seek it. Wholesale entry by banks into the insurance business will create no new capital source, no new jobs, no new services. The bankers themselves neither pretend to be better salespeople, nor claim to have better insurance products or service, to offer better prices, or to be more available. However, they know that they can get the insurance business because of the credit relationship. If they succeed on this basis, neither the public nor the insurance industry will be well served.

I will be happy to answer any questions.

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

Before the
COMMITTEE
on
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

on

BANKING DEREGULATION

January 23, 1987

Statement Made By:

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Mr. Chairman and members of the Committee, my name is Robert Googins, and I am Executive Vice President of the Connecticut Mutual Life Insurance Company. I am appearing today on behalf of the American Council of Life Insurance. The ACLI has 635 member companies who account for 94% of the legal reserve life insurance in force in the United States.

We appreciate the opportunity to appear before this Committee and present our views on several significant issues, including the need for Congress to address the state bank or so-called South Dakota loophole and, relatedly, the propriety of affording commercial banks expanded insurance powers.

THE ROLE OF CONGRESS

At the outset, I would like to make one observation concerning Congress' role in the establishment of national banking policy. While recognizing that the widely divergent views of industry make Congressional action in this area largely a no-win situation, the fact remains that you are being preempted from any meaningful role in the establishment of contemporary national banking policy. Your silence over the past several years has emboldened regulators to the point that they openly attempt to modify statutes by regulatory fiat and, in so doing, impose on others their parochial view of how the marketplace should operate. To these regulators, the intent of Congress in enacting these statutes is of no relevance. What is relevant is the likelihood of a judicial challenge.

Indeed, the courts and not the Congress have become the final arbiters of what can and cannot be done in the marketplace.

Some suggest that this is not an unhealthy situation. I believe they are seriously mistaken. The cost to business of having to resort to litigation to test every major regulatory decision and every major marketplace innovation is tremendous, not only in legal fees but in opportunity costs and uncertainty. And, as I am sure you fully appreciate, these costs are ultimately passed along to consumers. Additionally, the outcome of a law suit is not necessarily consistent with sound and rational banking policy. Courts are increasingly called upon to apply yesterday's laws in the context of today's situations. Unlike Congress, the courts can not update the laws to accommodate existing or evolving policy objectives. Parties that might well be willing to compromise in a legislative forum do not have that option in a judicial forum.

It is for this very reason that we believe Congress must reassert its authority to repeal, revise or reaffirm the laws governing financial intermediaries. I would add that simply because you find that a particular law separating banking and commerce is increasingly incapable of coping with today's marketplace, it does not automatically follow that the law should be repealed.

If the law's objective is still valid but is being frustrated by changed circumstances, it should be revised to make it once again effective. The true litmus test is whether laws have been

effective in fulfilling the purposes for which they were arguably enacted. The fact that the U.S. banking system is generally perceived as being one of the soundest if not the soundest in the world suggests that the statutory framework governing that system should be updated and preserved, not discarded.

STATE BANK LOOPHOLE

Of principal concern to insurance companies is the state bank or so-called South Dakota loophole. This loophole involves the efforts of commercial banks to circumvent the insurance limitations of the Bank Holding Company Act ("BHCA") through the acquisition of state chartered banks invested with broad insurance powers. Because some members of this Committee are new to this issue and because there has been some confusion in the past over what this loophole entails, let me take a few moments to explain it.

The origins of the state bank loophole can be traced back to the 1982 amendments to the BHCA enacted as part of the Garn-St Germain Depository Institutions Act. Despite pressure from the banking industry to give banks expanded insurance powers, Title VI of Garn-St Germain laid down strict statutory prohibitions on the range of insurance activities permissible for bank holding company systems Title VI was, for the most part, not new law but rather a codification of existing interpretations of the BHCA rendered by the Federal Reserve Board.

Faced with this substantial barrier to expanded insurance powers at the federal level , several money center banks immediately turned the to the states in an effort to circumvent the newly expressed Congressional intent. They were successful in persuading the South Dakota legislature to enact a law authorizing banks chartered in that state to engage in "all facets of the business of insurance." The law also permitted out-of-state bank holding companies to acquire South Dakota banks.

The theory underlying the banks' strategy is that there is an ambiguity or loophole in the language of Title VI which, if interpreted favorably to bankers, leads to the conclusion that the insurance limitations of the BHCA govern all entities in a holding company system except banks and their subsidiaries. Thus, through the acquisition of a South Dakota bank invested with broad insurance authority, a holding company could arguably engage in insurance activities that it is expressly prohibited from engaging in directly by virtue of Title VI.

The idea that while a bank holding company may not own an insurance company, it may own a bank that owns an insurance company contravenes the clear intent of Congress in enacting Title VI and is anathema to one of the fundamental objectives of the BHCA -- the separation of banking and commerce. There is little utility in having a federal bank holding company statute if every state can use its own vision of the financial services marketplace to override federal intent. By utilizing permissive state banking statutes, a bank holding company, through the acquisition of state chartered banks, would be free to exercise broad nonbanking powers in total disregard of the specific limitations of federal law.

This is certainly not the way in which the dual banking system was intended to operate.

Confusion as to just what is meant by reference to the "South Dakota loophole" has arisen because the South Dakota law has a peculiar wrinkle. It limits the ability of a state bank to exercise insurance powers within South Dakota, with the anomalous result that the bank can conduct a general insurance business in 51 other jurisdictions but not in South Dakota. It is this protectionist aspect of the South Dakota law -- a provision which bankers included to deflect the opposition of South Dakota insurance agents -- that is frequently misconstrued as the abusive "loophole" that must be closed. While it may be desirable to prohibit South Dakota or any other state from utilizing such a provision, this is not a matter of particular concern to the insurance industry.

An important point to bear in mind is that there has not as yet been a definite decision by regulators or the courts holding that the state bank loophole is viable. To date, the Federal Reserve Board has been unwilling to give state bank subsidiaries of bank holding companies carte blanche authority to conduct whatever powers a state legislatures may deem appropriate. By the same token, the Fed has been unwilling to promulgate rules establishing clear federal jurisdiction over state bank subsidiaries of bank holding companies. The point is that Congress seldom has the luxury of closing a loophole before it has been thoroughly exploited. Making clear at this time that the state bank loophole is not a viable avenue of bank deregulation would not result in any significant disruption of the marketplace.

LEGISLATIVE SOLUTION

We believe that the most effective way to address the state bank loophole question and prevent unintended abuses of the dual banking system is to make clear that bank holding companies and all of their subsidiaries are bound by the provisions of the BHCA. That is the approach that was taken by Senator Dodd in a provision he added to S. 2851, which passed the Senate in 1984. This provision simply makes clear that the insurance limitations of the BHCA apply to all parts of the holding company system, including state bank subsidiaries. Specifically, the language would amend Section 4(c)(8) of the BHCA by inserting between the words "bank holding company" and "to provide insurance" the words "or any bank or nonbank subsidiary or affiliate thereof."

It is important to understand that the Dodd language is in no way an infringement upon states' rights. It preempts no state law -- not even South Dakota's -- and does not effect in any way the right or the ability of a state legislature to authorize its domestic financial institutions to conduct whatever insurance or other nonbanking activities are deemed appropriate. It effects only those state chartered banks which elect to organize in holding company form. So long as a state chartered institution is not a subsidiary of a federally regulated bank holding company, the Dodd language is inapplicable.

There is good reason to differentiate between unaffiliated or freestanding state banks and those that are subsidiaries of a bank holding company. State banks are not forced to become part of bank holding company system. Rather, they elect to organize in holding company form for the purpose of realizing some benefit, such as obtaining substantial tax advantages over freestanding banks or avoiding state bank branching restrictions. By electing to take advantage of the benefits made available by the BHCA, these banks must be willing to accept the Act's restrictions, including those pertaining to insurance.

NONBANK BANKS

We believe that closing the state bank loophole is even more important in view of efforts to close the nonbank bank loophole. The nonbank bank and state bank loopholes are reciprocals -- nonbank banks enable insurers and other nonbanking entities to enter the banking business and the state bank loophole enables bank holding companies to enter the insurance and other nonbanking businesses. Given the highly competitive financial services marketplace, closing one loophole without closing the other would result in competitive inequities. We support closing the nonbank bank loophole, but only if the same legislation closes the state bank loophole.

D.C. LOOPHOLE

I might add that the language we support for closing the state bank loophole also addresses the efforts by certain entities to expand their nonbanking powers through the establishment of banks chartered in the District of Columbia. While District banking officials have not considered whether it would be appropriate to invest locally chartered banks with broad nonbanking powers such as insurance, the Comptroller of the Currency, the chartering authority for a group of applicants seeking to establish D.C. chartered banks, has begun granting these applications without reservation. The Dodd language would treat D.C. chartered banks in the same manner as state chartered banks. That is, a District bank would be free to conduct any insurance activity expressly authorized by its chartering authority so long as it does not become a subsidiary of a bank holding company. Once part of a holding company system, the bank would be governed by the insurance limitations of the BHCA.

SAVINGS BANK LIFE INSURANCE

One additional aspect of closing the state bank loophole that warrants mention is the effect on savings bank life insurance ("SBLI"). Connecticut, Massachusetts and New York presently authorize savings banks to engage in the underwriting and sale of life insurance products on an intrastate basis. Individual savings banks in those states as well as their trade associations have leveled criticisms at the Dodd language, arguing that it would impair their ability to conduct SBLI.

As noted above, the Dodd language would not extend the insurance prohibitions of the BHCA to savings banks that are not subsidiaries of bank holding companies. Thus, most state chartered savings banks would be free to continue their SBLI activities to

the full extent authorized by state law. Nor does the Dodd language repeal or preempt the power of states to authorize their institutions to conduct broad nonbanking activities, including SBLI.

Some have suggested that where a savings bank wishes to organize in holding company form, the Dodd language may pose unintended problems. Assume, for example, a situation where there is no commercial bank involved in the holding company system and no effort to broaden the insurance activities in which the savings bank can engage directly. Should the Dodd language mandate cessation of all SBLI activity in this context? Perhaps not, but the simple fact of the matter is that the BHCA draws no distinction between state chartered commercial banks and state chartered savings banks.

Absent some clarification of the state bank loophole by Congress, insurance companies now face the prospect of resolving this issue in the courts. In a posture of litigation, one can not afford to differentiate between the situation described above and blatant efforts by commercial banks or their holding companies to exploit the loophole. A court is simply going to identify the winners and the losers on this point. It will not seek some middle ground that may be more in concert with prevailing notions of appropriate banking policy. Congress, however, is in a position to develop a compromise if circumstances warrant, and that is why we believe Congress and not the courts must address these and other important issues confronting the financial services industry.

SMALL TOWN INSURANCE AGENCY ACTIVITIES

We also note that both the Comptroller of the Currency and the Federal Reserve Board have significantly liberalized by ruling and regulation the constraints under the National Bank Act and the BHCA on bank insurance agency activities in towns with a population of 5,000 or less. Both these actions are indicative of the disregard regulators have today for the intent of Congress in enacting these exemptive provisions in the first place.

We believe these situations need to be addressed by Congress and will be happy to work with this Committee to fashion an appropriate legislative solution.

MYTHS CONCERNING BANKING AND INSURANCE

We would now like to turn to a number of myths which have been circulating in connection with bank attempts to acquire expanded powers.

The Encroachment Myth

According to some deregulation proponents, the principle reason for banks seeking expanded powers is the encroachment into their traditional activities by other financial service providers. In fact, however, the degree to which insurers are engaged in banking activities is minimal, particularly when viewed in light of the insurance activities of banks with grandfathered agency operations and the insurance activities in which banks are expressly authorized to engage under the BHCA, such as credit insurance.

This is not to say that current insurance activities by banks are terribly significant, but as a relative matter, their insurance operations are much more extensive than our banking operations. I suspect that the same is true for the securities industry whose banking operations are most likely dwarfed by the private placement and discount brokerage activities of banks.

A look at the current litigation involving financial service providers is also instructive: in virtually every case it is the banks who are being challenged for their attempts to invade the insurance, securities, and real estate industries, not the other way around.

The Foreign Competition Myth

A similar myth advanced by bankers and some regulators is that banks need expanded powers to meet foreign competition. Recently, the fact that Japanese banks now dominate the list of the world's top 10 financial institutions has been cited as evidence of the ruinous consequences of the outmoded and unreasonable limitations on the nonbanking powers of U.S. commercial banks. Putting aside legitimate foreign trade concerns, we suggest that the Japanese banking experience is worth noting, but for a very different reason. It stands for the proposition that it is not what you do, but how you do it that is important.

The fact of the matter is that Japanese banks are not permitted to engage in the Japanese insurance business nor do they engage in the Japanese investment banking business. Japanese banks do invest in overseas insurance and securities firms, but they do so in the same manner in which U.S. banks invest in foreign insurance and security entities.

In terms of powers, the unfortunate conclusion to be drawn from the dominance of Japanese banks may simply be that they are more proficient at the business of banking than their U.S. counterparts. And the solution to that problem has nothing to do with dabbling in unfamiliar nonbanking enterprises.

The Consumer Benefits Myth

A third myth involves the notions that the entry of banks into the insurance business would produce a number of significant benefits to consumers.

For example, it has been claimed that bank entry into insurance (1) might have prevented the liability crisis, (2) could save consumers $8 to 10 billion per year, and (3) would produce substantial competitive benefits resulting in long-term industry efficiency.

As discussed below, we have tried to find a credible factual basis to substantiate each of these claims but have been unable to do so.

Banks Effect on the Liability Crisis - Bankers have repeatedly implied in advertising and congressional testimony that the capacity shortage in liability insurance, often referred to as the liability crisis, might have been averted or could be prevented from reoccurring if banks were permitted to enter the insurance market thus, in their words, "add(ing) substantial new underwriting capacity." Clearly, the impression the bankers want to create is that they would jump right in to provide liability insurance for toxic waste dumps, day care centers, medical malpractice and ski-lifts. That is not the case. In April of last year in testimony before a subcommittee of House Committee on Energy and Commerce, Edward Yingling, speaking on behalf of the ABA, had this to say, "Speaking frankly, banks observing the present disaster in commercial property/casualty field would not rush in to fill this void were they granted underwriting powers today. Bank entry into underwriting would start slowly and focus on actuarially predictable sectors while leaving the more exotic insurance products to the experts."

Put another way, what Mr. Yingling was saying was that the banks would like to skim some of what they perceive as the low-risk cream off of the insurance business, (i.e. life insurance and annuities) but don't intend to get into any of the clearly high risk areas such as commercial liability lines. While that is certainly an understandable position, it is hard to see how banks' entry into insurance on those terms could have had any effect on the capacity shortage in liability insurance. For the record, I would like to state that there is no capacity shortage in the life insurance business.

$8 to 10 Billion in Annual Consumer Savings- Bankers have repeatedly asserted that they could save the consumer $8 to 10 billion annually in insurance costs if permitted to enter the business. This claim is based on three assumptions - capture of 100 percent of the market for life and health insurance and annuities, a 10 percent absolute cost savings in commissions and home office expenses, and a 100 percent pass-through of that savings to consumers. We cannot uncover a rational basis for any of these assumptions.

First of all, insurance and banking industry sources generally agree that banks might realistically expect to achieve a 5 to 10 percent penetration of the market, not 100 percent.

Secondly, group employee benefit plans, which account for more than 50 percent (measured by premium volume) of the life, health, and annuity market, are typically funded with contracts that have combined commission and home office expense factors in the range of 1 to 2 percent of premium. That being the case, it is preposterous to assert that bankers would achieve a reduction in expenses on those products equal to 10 percent of the premium.

Most of the remaining premium income for insurers comes from individual life insurance policies. Premiums for new individual life insurance policies were about $18 billion in 1985. Suppose banks were now permitted to enter this market. If they were able to capture 10 percent of next years sales, they would receive less than $2 billion in premiums. For now, we will accept the bankers' unsubstantiated assertion that they possess an inherent distribution efficiency which would permit them to reduce costs by 10 percent.

Applying the 10 percent figure to less than $2 billion in premiums gives us less than $200 million in net savings. Even if we also accept the assumption of a 100 percent pass-through to consumers, the resultant hypothetical savings would be a far cry from $8 to 10 billion per year. Over a period a years this figure might be expected to increase somewhat, although renewal business is subject to much lower commission and expense structures than new business and thus would not reflect the same level of hypothetical savings.

Even this hypothetical figure retreats to the vanishing point, however, when we consider that the bankers' self-proclaimed cost advantage is predicated primarily on the elimination of the agency distribution system. This is not the revolutionary idea bankers would have us believe. Many insurance companies have been experimenting with non-agency distribution systems for some time and have enjoyed some success. Simply put, these companies fill a niche in the market. If direct marketing had showed the potential to replace the agency system, it would have been generally adopted by the industry long ago. The fact remains that agents account for 98% of life insurance sales. Moreover, there is no reason to assume that bankers would not also use an agency system of distribution were they to obtain full insurance powers.

Consider also that the banks' acknowledged reason for entering new businesses -- additional profits -- casts considerable doubt on the prospect that any hypothetical cost savings would be passed on in full to consumers. Bankers want to enter the insurance business primarily because they think it will be profitable. In view of that, we should not expect them to use low margins in pricing their products to consumers.

The best example we have for predicting how consumers would fare in their insurance dealings with banks is credit life and accident insurance, which is currently sold by nearly all banks in connection with their loans. Bank involvement in credit insurance has produced an astonishing record of consumer abuse not only with respect to coercive sales practices (tie-ins) but also insurance charges far in excess of the rates available for similar insurance from non-bank sources in the same market.

If the bankers really wish to reduce consumer cost, they might start by reducing credit card rates and service charges and by supporting rather than opposing legislation on funds availability and life-line banking.

Competitive Benefits of Bank Entry - Bankers claim that their entry into insurance would result in significant but unspecified competitive and efficiency benefits. We assume that such a statement is based on the basic economic theory that the more sellers there are in the marketplace, the more competition there is, thus driving down the average price and ultimately allowing the most efficient producers to drive the less efficient ones out of the market. This simplistic assessment ignores important real-world aspects of the insurance marketplace.

First, based on the past history of financial service diversification, there is the likelihood that a significant percentage of new bank entrants into the insurance business, particularly in an underwriting capacity, would simply acquire existing insurance entities rather than attempt de novo operations. Such a process would not produce significantly more competitors but, rather, new owners of existing competitors.

Second, insurance is by all objective standards a highly and increasingly competitive industry, characterized by low concentration and ease of entry. Virtually every type of business, save banks, may own an insurance company. Retailers, manufacturers, brokerage houses, grocery chains and others all have insurance subsidiaries and compete heavily for the insurance dollar. Evidence of this high degree of competition is the fact that the cost of basic insurance protection has declined more than 20% in real dollar terms since 1960. The notion that the banks, who have suffered record numbers of failures in recent years due primarily to mismanagement, possess an inherent marketing or administrative skill which has somehow eluded all other types of business enterprises must be greeted with skepticism.

WHY KEEP BANKING SEPARATE?

Based on the foregoing discussion, the question may legitimately be asked, if every other type of business can engage in insurance operations and banks have no inherent administrative or marketing efficiencies, why not let them enter?

The answer is simply that banks do not come to the financial services marketplace as "just another competitor". If General Motors or AT&T or IBM wish to enter the insurance business we would welcome them. But when Citicorp wants to do it, we have a problem. We do not object to competition, but we do object to unfair competition.

That banks occupy a unique position in the financial services marketplace is not seriously in dispute. The fact that the federal safety net exists is testimony to the high premium that our society places on a stable and dependable banking system.

The Federal Safety Net

The components of the federal safety net have been the subject of testimony before this Committee many times but they bear mentioning again. They include federal deposit insurance, access to the Federal Reserve discount window, and merger assistance, not to mention various tax advantages. Make no mistake, banks are special creatures in our system, and they should be. But that does not mean that the advantages of the federal safety net were intended to be a bootstrap for banks to engage in nonbanking endeavors.

The federal safety net enables banks to raise money in the capital markets at a lower cost than other borrowers. It permits banks to pay lower returns on borrowed funds and serves to overcome investor or depositor reluctance to place funds with them.

Permitting banks to utilize these lower cost funds to capitalize subsidiary, non banking businesses, such as insurance,

is patently discriminatory and unfair to all nonbanking competitors. The following quote bears directly on this issue:

> We do not believe that non-depository institution activities should be conducted through a subsidiary or service corporation in which a bank or thrift has a direct equity investment. Again, the invest- ment would be at risk if the subsidiary's activities were to falter, and the funds for the investment would be raised with federal assistance not available to non-depository institution competitors and at a cost advantage to the bank or thrift.

That probably sounds like a disgruntled insurance executive's reaction to a banking deregulation proposal. In fact, it was a statement made before Congress by then-Treasury Secretary Donald Regan, the architect of the Administration's banking deregulation program.

Beyond the issue of capitalization costs, however, is the issue of credit leverage or tie-ins.

Credit Leverage

Bank customers are in an inferior bargaining position when they seek extensions of credit and are, therefore, extremely susceptible to the suggestion, either expressed or implied, that they might be more likely to get a loan if they agree to purchase additional bank services, such as insurance. In such situations, consumers are not concerned with the price or quality of the bank's insurance product, they simply want to protect their source of credit.

Thus, even with the extensive system of regulation of credit insurance in most states and express prohibitions against tie-in

The CHAIRMAN. Thank you very much, sir.

Mr. Gerard, were you the Treasury official in the Ford administration who advised President Ford to tell New York City, when they sought a Federal bailout, to drop dead?

Mr. GERARD. No, sir.

The CHAIRMAN. You were not.

Mr. GERARD. I don't think anybody in the Treasury advised President Ford. I think, as I recall, the position of the Treasury was strikingly similar to your own position, namely, that New York——

The CHAIRMAN. My position was that they should drop dead. [Laughter.]

Mr. GERARD. Not quite.

The CHAIRMAN. I was going to congratulate you. [Laughter.]

But let me tell you, Mr. Gerard, you and I come to this from different viewpoints. You work with Morgan-Stanley, and when I went up to Morgan-Stanley 47 years ago applying for a job, they said, "Get lost." [Laughter.]

They told me——

Mr. GERARD. The same thing happened to me the first time too.

The CHAIRMAN. They told me to go to JP Morgan & Co., which I did. The future chairman of the Banking Committee did not get the viewpoint of the investment bankers. Instead I got the viewpoint of the commercial bankers. [Laughter.]

But I come to this without any bias whatsoever, as you know. [Laughter.]

But let me ask you this question. One of the major objectives of the Glass-Steagall Act is to prevent conflicts of interest arising when a firm can act both as a lender and as a securities underwriter.

As we saw in the 1920's, banks sometimes underwrote dubious bonds in order to bail out their loans, and made questionable loans in order to support their underwriting. In recent years, we've begun to see similar conflicts occur in the securities industry. For example, some securities firms actually loan their own money to companies engaged in hostile corporate takeovers.

SECURITIES FIRMS IN UNDERWRITING

If we are to maintain the principles of Glass-Steagall, should we extend them to the securities industry and prohibit all securities firms from making loans?

Mr. GERARD. In your question, Senator, I think you put your finger on the distinction. When we decide to use some of our own capital in a transaction, it is our own capital. It is the capital that either the partners of the firm or their stockholders, after full disclosure, have decided to put at risk in the securities business.

When the banks make a loan, it is not their money, it is the public's money guaranteed by the Federal Government.

And that is the distinction between the two industries.

The CHAIRMAN. Mr. Silver, you assert that bank-sponsored mutual funds were, and I quote "a large part of the financial firestorm that led to the Glass-Steagall Act."

Mr. SILVER. Yes, sir.

The CHAIRMAN. Why don't the Securities Act of 1933, the Securities Exchange Act of 1934, and the pervasive regulations of investment companies under the Investment Company Act of 1940, provide adequate safeguards?

Mr. SILVER. Well, sir, first, let me say that they don't provide adequate safeguards because when they were enacted, they were enacted against a background of the Glass-Steagall Act already on the books. In other words, banks were excluded from the securities business by the time that these securities laws were passed. So if you do decide to go down the road of permitting bank entry into mutual funds, I think it would be well to take the advice of two successive SEC Chairmen, Harold Williams and John Shad, who pointed out that the securities laws, as they exist today, are completely inadequate to deal with bank conflicts of interest and that additional safeguards would be needed. And I think Chairman Volcker has made that point on several occasions.

However, getting back to your fundamental question, the fact is that the Congress, fresh with the memory of this firestorm, made two decisions. One, they decided that the conflicts in the securities business should be handled through disclosure under the Securities Act and through regulation under the Exchange Act and a few years later under the Investment Company Act of 1940.

That same Congress, with the facts of the firestorm still fresh in their memories, made a different decision with respect to banking, and that was that commercial banks should not be in the securities industry. And that is the record I was trying to bring to your attention this morning.

The CHAIRMAN. As you recall, in 1984, this committee and the Senate as a whole, did pass, by an overwhelming vote, 89 to 5, a measure that gave banks the right to underwrite revenue bonds, mortgage-backed securities and commercial paper. We limited it, and I thought that limit was prudent and careful, particularly in view of the fact that revenue bonds did not exist at the time of Glass-Steagall. They provide at least as much security under most circumstances as general obligation bonds. Commercial paper is something that the banks deal with constantly, and they are short-term commercial loans, in effect, which is really part of the banking business, and of course, mortgage-backed securities is another kind of security that the banks have a special expertise with.

So we limited it to that. What is wrong with that principle?

Mr. SILVER. Well, Mr. Chairman, it would take us quite some time to go through them one by one, but let me just start with the last one you mentioned.

It was a specific abuse of the 1920's that the banks packaged their bad loans into investment trusts and sold them to the public. Look at the experience of Bank of America 2 years ago when in effect, the bank acted as underwriter to a batch of mortgages, bad mortgages and unloaded them through mortgage-backed securities, in effect, an investment trust on a batch of S&L's. That was the classic conflict of interest.

Now I don't see how the packager and the underwriter and the distributor of the security is not in an inherent conflict of interest.

In effect, they were underwriting the mortgage loans which they were warranting.

The CHAIRMAN. My time is up. Senator Heinz.

Senator HEINZ. I think Senator Graham is ahead of me.

The CHAIRMAN. Oh, yes. That is correct, although we go back and forth, but Senator Heinz is being gracious. Go right ahead, Senator Graham.

Senator GRAHAM. Mr. Silver, I was very intrigued with your history of 1927 forward. I would like to ask some prophetic questions, particularly, in the context of the increasing influence of nondomestic financial institutions on American capital markets.

What do you think that says about the application of 1927 history to 1987 economic realities?

MONEY MARKET FUNDS STAND AT $230 BILLION

Mr. SILVER. Well, sir, first, I think that the premise that the big bang in London or the sumitomo Goldman deal really provide a basis for legislation, I think, is much, much overblown. We have sat through recurrent explanations over the years as to why they should be in one aspect of the securities business or another. I think the witness on the last panel was very candid. He said that they wanted to be in the mutual fund business, because that is where the money is. Well, I can tell you that it is not in the money market funds. They stand at $230 billion, exactly where they were when the Garn-St Germain Act authorizing bank money market deposit accounts was passed in 1982. So that it must be the equity funds that the bankers want, and that puts banks right back into the middle of the equity business from which you excluded them in 1933.

As we said in our written statement, times do change, and maybe a thorough restructuring is what is called for. Perhaps the winds of competition should blow both ways. Maybe the Glass-Steagall Act should be repealed in total along with the McFadden Act's geographical restrictions and let everybody get into everybody else's business.

But the Glass-Steagall Act was not enacted to deal with these kinds of structural problems. It was enacted to deal with the fallibility of human nature. And I don't think that human nature has changed since 1927.

Senator GRAHAM. To any members of the panel, do you see a potential in the financial markets that we have seen in reality in the industrial sector, in terms of the penetration of non-U.S. enterprises? Is our financial institution going to be the steel and automobile industry of the 1990's, in terms of foreign competition? And if not, why not. And if so, what should we be doing about it?

Mr. GERARD. Senator, Let me reluctantly try to respond to that question. The answer is, "No." I don't see that threat. I think clearly the growth of foreign financial institutions in some of the stronger industrialized countries in the world, primarily Japan and Germany, and their role in this market is obvious. At the same time, the growth of both U.S. organizations and U.S. commercial banking organizations and U.S. securities firms in the international markets, primarily in London and Tokyo, is equally clear.

I think, basically, what we have, and I think Glass-Steagall is a part of it. The Glass-Steagall Act that applies here, as well as the virtually identical legislation that applies in Japan, where the bulk of the foreign competition is coming from, is an international system, where both currencies and financial entities cross international borders at will. I mean, obviously, those of us in the securities industry, as well as our colleagues in the commercial banks, I am sure, would prefer that some of the foreign countries in which we do business were as receptive to competition from foreign institutions as we are.

But having said that, and speaking strictly for myself, you know, I am a free trader, and I don't think you solve anything by closing the borders of this country to foreign financial institutions. We think we can compete with them. We think we have competed with them, and we think the commercial banks have competed with them both here and abroad.

The CHAIRMAN. Thank you very much. Senator Graham, are you through?

Senator GRAHAM. Yes.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

UNFAIR TYING ARRANGEMENTS

I would like to ask Bob Gerard a question, although Dave Silver talked about it briefly. With respect to unfair tying arrangments and conflicts of interest, would you just elaborate on what you would see with respect to these dangers if commercial banks were granted underwriting and additional securities powers?

Mr. GERARD. I would be delighted, Senator. Let's just talk about tying in the abstract for one second. I mean, tying has been a per se violation of the antitrust laws in this country, criminal violation, for many years. And the reason is that both the Congress and the courts have consistently found that when an enemy has economic power in one product or service and uses that economic power to get a customer to purchase another product or service, normally that second product or service is purchased on terms that are not competitive.

I think we have seen that in the securities market. I think we've seen it most graphically in the sectors of the revenue bond market which have been eligible for commercial bank underwriting over the years. I can't think of more than two or three transactions out of literally thousands in which a commercial banks has participated as a lead underwriter and which at the same time, the commercial bank has not provided some other product or service, namely, a letter of credit, a guarantee, a short-term loan, or what have you.

Now that's anecdotal. I mean, I've been in the revenue bond business for about 10 years, and my experience is that commercial bank participating in underwriting of revenue bonds in those areas where it is allowed to them, as well as those areas where Glass-Steagall now prohibits it, but they call it private placements, not underwriting, even though it looks and smells like underwriting to the rest of us. In virtually every case, there has been a provision of an unrelated product or service.

Senator HEINZ. Now what are the dangers of that?

Mr. GERARD. Normally, that unrelated product or service which is necessary to the transaction comes at an uncompetitive price. In other words, if a bank or the underwriting service is provided at an uncompetitive price. If city X needs a letter of credit, the bank says:

> Fine. We will give you a letter of credit at the same price this other bank will give it to you, but we are going to charge you twice as much to do the underwriting as Morgan-Stanley, or Goldman Sachs, or First Boston.

That is the risk, and that is the kind of thing, Senator Heinz, that we think ought to be looked at. We don't think this Congress has ever sat down in the way they made a special study of the securities market for the SEC's assistance in the early 1970's and taken a look at the facts.

I mean, sure, if you get a mayor up here and you ask him, you know, did your local bank put unfair pressure on you, he is going to be reluctant to say yes, because he doesn't know when he's going to need them again for a loan. But if you get some professionals and some academics out around the country to take a survey of what actually happens in the marketplace and to report back in a disciplined way, you might get a very different picture of the relative roles of a financial institution. That's what we think ought to be done.

Senator HEINZ. I would say to my friend, the chairman of the committee, I hope we will find a way to do something like that, because, obviously, you have an interest, the mayors have an interest, and we need some objective facts on this issue. That would be of great assistance to the committee.

So I thank you very much for that suggestion, Bob.

Let me, in the time remaining, turn to our insurance group here. First, I would like to announce that next week I will be introducing legislation to close the South Dakota loophole. It will be very similar to the Dodd-Heinz, Heinz-Dodd legislation of previous years. Members of the committee that want to cosponsor will have the opportunity to do so. We will not introduce that prior to Tuesday, in any event.

UNITARY S&L LOOPHOLE

But I do want to ask this question. Obviously, both of you have testified in support of closing that loophole. There's one loophole that you didn't testify in support of closing, unless you did it while I was out of the room. If you did, I apologize. It was what I call the unitary S&L loophole. Under current law, a savings and loan holding company, if it is a unitary and it's S&L sub has 60 percent of its assets in residential mortgages and related assets can have a separate affiliate that is engaged in insurance activities.

First, am I right? Second, if the South Dakota loophole is a problem to you, why isn't that?

Mr. HUGHES. I think, as we have considered that question over the years, particularly since 1982, when S&L's received broader authority, we have come to the conclusion that to the extent S&L's look more like commercial banks, perhaps something should be done in this area. To the extent S&L's want to act as S&L's, which is slightly different than commercial banks, then perhaps the present law is adequate. But I think you have to look back to 1982 and the changes that were made in 1982 and then determine what has happened since then.

Senator HEINZ. Do you have a comment to make on that, Mr. Irons?

Mr. IRONS. Senator, we take the same position on this unitary S&L loophole as we would closing the South Dakota loophole. We believe that the loophole should be closed.

Senator HEINZ. Thank you. My time is expired.

The CHAIRMAN. Thank you, Senator Heinz. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. Mr. Silver, when we passed, in the Senate, the comprehensive banking bill a couple years ago, mutual funds were left out, as you know. Do you feel that would be wise, if a comprehensive banking bill is passed this time?

Mr. SILVER. Well, Senator, for the same reasons as in 1984 I hold that same belief in 1987. I would add, in all seriousness, I don't think that the committee made that decision to exclude mutual funds because I'm more handsome or we have a more powerful lobby than the ABA, because neither is true. You made that decision because, as I said before, you were persuaded that mutual funds, bank-sponsored mutual funds were right at the core of the Glass-Steagall Act and the problems that Congress tried to cure in 1933, and I think that decision should stand.

Senator HECHT. No reason to change one way or the other, then?

Mr. SILVER. No, sir. There have been no additional arguments made. I think Senator Proxmire, the chairman, has pointed out on several occasions that all the arguments have been made, that the same arguments have been made year after year and are becoming repetitious, and so he wants to move speedily. I think that is a recognition that nothing has changed in this area, at least, since 1984.

Senator HECHT. Thank you. Mr. Gerard, let me ask you a question, and that is about foreign competition, because I am hearing more and more about that. I was in England right before the big bang, and I have in the Far East. Would you address that? What is foreign competition doing to you on securities right now?

Mr. GERARD. By and large, I think foreign competition has been very healthy. I think, as I alluded to in my response to Senator Graham earlier, Senator Hecht, but our biggest concern is that we are not allowed to compete as freely abroad as our foreign competitors compete in this country. We don't think that foreign financial institutions have any inherent competitive advantages over us under our current system in this market. We compete with them fairly and fully here and in London, as well as in the other financial markets of Europe. We are concerned, to some degree about the limited scope allowed to certain U.S. financial institutions in the Far East, but we certainly wouldn't characterize the overall picture as one giving rise to concern or one that is inherently unfair.

Senator HECHT. Thank you very much. I have no further questions. Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Gentlemen, I apologize for not being able to be present earlier. Therefore, if some of the questions I put have already been asked, I hope—I know you will understand. I hope you will excuse it.

CONCERN ABOUT PIECEMEAL CHANGES

First of all, I want to ask, to what extent there is a concern that if you make these piecemeal changes in the cleavage between commercial and investment banking—suppose you start from a proposition that at some point there is a validity to the cleavage, as you move along the spectrum of activities that you are talking about, to what extent, though, if you make these piecemeal changes, would you reach a point where a separate investing banking would no longer be feasible, even though the activity left to it might, in fact, there might be good arguments that that should be done separately, but because the area of operation has been so limited over time through these changes, is no longer viable?

Would that happen and is that a concern?

Mr. GERARD. Let me respond, Senator Sarbanes.

You know, I think that's precisely the issue before this committee right now. I think, basically, the proposals of the chairman to grant these additional powers would eliminate the restrictions of Glass-Steagall with respect to every aspect of the securities business, except the underwriting and trading of corporate debt and equity.

I would point out that one of the pressures, if you will, on this committee, as the chairman recognized in his opening statement, is that legislation doesn't seem to have the same compelling impact on the actions of the regulators and of the State banking regulators as it used to in this country. At the same time that we are, in effect, considering the granting of powers that would give commercial banks, call it 80 percent of the securities business, the same commercial banks that are saying that's all they want in this committee, are before the New York State regulator, before the Delaware Legislature and before the D.C. corporation counsel and saying, give us the power to underwrite and trade in corporate debt and equities through a State bank subsidiary in these jurisdictions.

So I don't think you can go this far without effectively repealing Glass-Steagall, but I would point out that you are only repealing it one way, because nothing in these regulatory actions or in these matters before the committee allow the securities industry to engage in what we know as commercial banking. And it may well be that after you study this, as some of the other witnesses have said, and as we said in our written statement, the only fair thing would be a total repeal of Glass-Steagall, allowing us to compete fully in the banking business and allowing the banks to compete fully in our business.

Now we don't think that is likely to be the right result, but if after a thorough comprehensive study, you do, that's certainly infinitely more desirable of a financial system in this country than this one-sided repeal that gives the big banks everything and the rest of the financial marketplace severe restrictions.

Senator **Sarbanes**. Well, let me just pick up on that point. What is the system, if you were writing the script, you would envision us having with respect to financial institutions?

Mr. **Gerard**. Without the benefit of further review and on the basis of the track record of the financial markets in this country since 1933, I think the current system—or should I say the current system before the bank regulatory agencies and the State bank supervisors decided to rewrite Glass-Steagall on their own, has worked very well for us.

Senator **Sarbanes**. What would you say to the argument that many of the reasons for the cleavage being established no longer exist and that safety and soundness, which I think are very legitimate concerns, because, obviously, if you don't have them, the whole system is falling on you, can be addressed in other ways, and that, therefore, perhaps it ought to just ought to be made wide open? In other words, instead of holding to the cleavage, let's move beyond moving one way only, but you just move both ways.

Mr. **Silver**. Senator, if I can take a shot at that. Maybe there have been such structural changes. Senator Graham pointed to the internationalization of the financial markets, generally—as a possible reason that we should go all the way to financial integration. I think that would be a very grave step and should be predicated on a decisive showing that we have to go in that direction. Until that time, I would repeat, I think, a comment I made before you arrived, and that is that the Congress in 1933, the Congress most contemporary to these problems, felt that the securities industry problems could be solved with a regulatory approach. However, being fresh to the debacle that had occurred, they thought that the decision should be to separate commercial and investment banking. And I am certain that the arguments were made back then that a regulatory approach would suffice there also. It was rejected by the Congress most contemporary to the experience.

Senator **Sarbanes**. Let me just ask one further question, and you alluded to it. To what extent do the developments internationally alter the framework in which we are dealing with these questions?

EFFECTS OF INTERNATIONAL BANKING ON THE DUAL SYSTEM

Mr. **Gerard**. I don't think, quite frankly, it is material. I mean, what one hears about international developments, and it's been implicit in some of the questions from members of the committee is the competition from the Japanese banks. When the Japanese banking and financial markets were restructed after World War II, a process in which we played a major role, Glass-Steagall was imposed in full force. Glass-Steagall, called, perhaps by another name, applies in Japan today, and yet the Japanese commercial banks have done extremely well, internationally, under those constraints. So I don't think the internationalization of financial markets is a justification in and of itself for eliminating the separation between commercial and investment banking.

I don't think internationalization in and of itself is a basis for making a change on the fact that we need to be bigger or engage in more activities. The major securities firms of this country are thoroughly competitive, internationally. The major commercial banks in this country are thoroughly competitive, internationally. As Dave Silver alluded to, if there is going to be a change to be made, it's got to be a two-sided change and one taken with a great deal of care and a great deal of hesitation, after a great deal of study, but a one-sided change, to change the way we compete, domestically, could have adverse implications for the securities industry, internationally.

We consider ourselves and a number of our major securities firm competitors to be very strong in London and Tokyo, the two other principal financial centers, internationally. If our ability to compete with the commercial banks, domestically, goes down, I don't know whether we can retain that strength.

Mr. HUGHES. Senator, I would just like to say for the record that, as far as insurance is concerned, the Japanese banks do not engage in that business. Also, the insurance business is very supportive of efforts to open up the international insurance markets, and we are encouraging competition with the Japanese.

The CHAIRMAN. Unless Senator Graham has further questions, go right ahead, Senator Sarbanes.

Senator SARBANES. Well, I just have one or two more. I apologize, Mr. Chairman.

I would like to ask the panel this question. Between maintaining the existing system as is and a two-sided change after very careful examination, where do you sort of come out between those two things?

Mr. GERARD. Well, let me state our position, which is, our guess is that a thorough and careful examination will result in the conclusion that the system as it is or as it was 2 years ago before all these regulatory activities took place, is the better way to go. That is our instinct. And we base that instinct on the last 50 years of experience, the last time, as Dave Silver referred to in his opening remarks, that Congress decided to give banks the powers in the underwriting business and took them away 6 years later.

So we think that is pretty good historical evidence, but we are open minded, and if, in your wisdom, and after you consider all the facts and ramifications, you decide that a true two-sided repeal of Glass-Steagall is the appropriate way to go, we would not have a major problem with that. As I say, our instinct is that that will not be your conclusion after a thorough study, but if there is going to be a change, it has to be a two-sided change.

Mr. IRONS. Senator, if I might add, from the insurance agent's point of view, we feel emphatically that things should stay as they were intended by Congress. We feel quite clearly that South Dakota loophole closure and the nonbank bank loophole closure should be passed and done quickly.

I talk from a point of view of dealing with the small business people. You weren't here earlier, but the small business representative talked about the lifeblood of our economy, which is small business. I think it is well recognized that over the last 5 to 10 years, that the new jobs in our economy have come from small business, not large business. And the large banks do not respond in a personal, understanding fashion to the small businessman.

The emphasis that banks place on efforts to expand their insurance powers are simply for their profit needs. The competition sales, instances of excessive zeal in the marketing of that coverage continue to arise.

The Federal Reserve Board's own study of credit leverage indicated that nearly two-thirds of bank borrowers purchase credit life or health insurance. And over 40% of those who purchase such insurance do so because they believe it is "required" or "strongly recommended." How many more agree to purchase such insurance simply because they believe that it will improve their chances of getting a loan?

I think the issue is best summed up by a quote from a 1984 article on the effects of banking deregulation on the consumer in Best's Review by Ralph Nader. Mr. Nader said: "The ability of banks to sell insurance to consumers who are in the process of getting a loan already has been demonstrated by the monstrously exploitive credit life insurance scam."

How do you prevent this sort of thing from happening? Obviously, having a law against tie-ins is not the answer. We believe that the opportunity to tie has to be removed, and that means requiring banks to stick to banking and stay out of nonbanking activities such as insurance.

Safety & Soundness Considerations

The spate of bank failures over the last several years has made it painfully evident that banks and their regulators are having difficulty handling their current complement of powers. It is unreasonable under these circumstances to suggest that bankers

be given additional powers which pose substantial additional risks, most of which are unfamiliar to banks and bank regulators.

We have never suggested that the insurance business is more risky than the banking business. What we have pointed out is that each business has its unique set of risks and these risks are substantial, particularly for the inexperienced. Our point is that the combination of banking and insurance would result in the aggregation of these risks and, in turn, jeopardize the safety and soundness of the banking system.

The dangers to institutional safety and soundness that result from combining the risks of disparate businesses are not appreciably lessened by using subsidiaries to house the additional activities. Federal Reserve officials have long recognized that subsidiary arrangements "are not likely to produce a situation in which the bank is immune from problems, risks or losses that might develop in such subsidiaries. In short, such a structure is neither a substitute for prudent management nor a fail-safe device for containing risks". Recent experiences in the marketplace have underscored the validity of this rationale again and again.

The public frequently perceives that the failure of one arm of an enterprise is the failure of the whole, and that fact should give you cause for concern. Laws and regulations can attempt to isolate parents from the liabilities of their subsidiaries, but they cannot dictate the public's perception of a situation. And, in the final analysis, such perception is often the most crucial element in determining whether an enterprise endures or fails at a time of financial crisis.

This effect is all the more acute in the case of depository institutions. As noted by Robert E. Litan of the Brookings Institution in a recent American Banker article,

> When nonbank enterprises fail, the ripple effects on other companies and on individuals are generally confined to narrow regions of the country or sectors of the economy. However, when banks go under, the consequences can be far more dramatic. The continued operation of the banking system, as well as the wider economy with which it is inextricably linked, rests entirely on the confidence of depositors in the safety of the institutions holding their funds. A bank failure, particularly one involving a large institution, can threaten that confidence, triggering deposit withdrawals, or runs, on healthy banks.

We concur in Mr. Litan's assessment on this issue and believe it is one of the strongest arguments against permitting the combination of banking and other forms of commerce.

Concentration of Economic Power

Concentration of economic power is a topic which has not received a great deal of attention in the debate over banking deregulation, but it is something which the members of this panel should think about very carefully.

It's no secret that the push for deregulation comes mainly from the large bank holding companies who already exert an inordinate amount of political and economic power. For example, the ten largest bank holding companies have combined assets exceeding those of the entire life insurance industry.

If existing restrictions on bank activities are relaxed, the prospects for expanded political influence by these giant institutions will be substantially enhanced.

CONCLUSION

We strongly encourage you to reassert your role in the formulation of national banking policy and halt the chaotic and often ill-advised deregulatory efforts of certain regulators. Both the public and this country's financial institutions will benefit from a carefully rationalized financial services marketplace. Toward this end, we urge you to prevent abuses, such as exploitation of the state bank loophole, that threaten to undermine the integrity of the marketplace.

question or premise that they put forward is ridiculous on its face. You cannot find a point across the country where banks, who do, under the existing law, have the ability to sell insurance do it competitively. They do not provide better services.

We feel the safety and soundness question runs deep here, runs very deep here, and we hope—I talk to you with two hats, that as an underwriter that I've just expressed and now as a State legislator. One of the things that I am tremendously concerned about with the South Dakota question is, I do not want to have to have our director of business regulation trying to work with the Comptroller of the Currency to figure out whose problem the failure was. That State bank, State-chartered bank that wants to come under the Bank Holding Company Act can do that. But, it has now changed its form and takes the restrictions that go with it.

In your wisdom, I hope that you will close both of those immediately.

COMPTROLLER'S DECISION IN OREGON

And the last point I would make in relation to Mr. Evans' comment about loopholes being frivolous statements, I think nothing is more absurd than the Comptroller's allowance of a bank in Oregon to be given the ability to sell insurance across this Nation because consumers asked for it. That is ludicrous. No one in New England, I am sure to say, has ever asked Oregon banks to come into Rhode Island to give them homeowners' insurance. This is a profitability question for those institutions. It does not run to the core of providing better services, sounder services, safer services.

I would say to all of you who understand the insurance product, today we have products that are called universal variable interest sensitive life. I have found that bankers don't even understand IRA's. I doubt that they will be able to effectively guide their clients with respect to those current insurance products.

We compliment the Chairman on his prompt action. We were very enlightened by Senator Heinz's comment this morning. We hope you will deal with these loophole closing measures, so that the consumer can have the protection that he needs. Put everybody back into the boxes. What we have heard this morning, really, is, when the barriers were let down, consumers were hurt, and what the banks are asking for now is to completely obliterate any lines on the premise that that will improve the competitiveness and safety and soundness of the marketplace.

I think what they are really saying is, we are screaming for profitability, and we are really not sure where we are going to find it. Give us every opportunity.

Mr. Evans' comment was very telling, I think, when you made the comment, Mr. Chairman, about General Motors outlet, and you said, should we take away their FDIC, and he said, fine. The reality really is, would that have helped the people in Illinois when Continental failed? They are not really concerned about the consumer. It is a profitability question, and I believe one of the first and foremost responsibilities of the legislator is to think of the consumer.

Senator SARBANES. Mr. Silver, did you want to add anything?

Mr. SILVER. Well, sir, I am afraid I really can't give you terribly much comfort, because I can see the implications of your question. I would simply remark that it took the social trauma of a 1929 to 1932 to exclude banks, restore the status quo as before 1927, and separate the two industries.

I don't think, without that kind of social trauma, the Glass-Steagall Act would have been enacted. It was part of the first 100 days' legislation. Once you cross that line again, I think that you would find it very, very hard as Mr. Irons has said, to put the genie back in the bottle. So it is a line, I think, that should be crossed only for the most compelling reasons. As I said, I am afraid my answer is not satisfactory, as I am dumping it right back in your lap.

Senator SARBANES. Well, that's all right. That's what we are here for. Thank you, Mr. Chairman.

The Chairman. Thank you, Senator Sarbanes, Senator Graham.

Gentlemen, thank you very, very much. It has been an excellent panel, and we can't thank you enough.

The hearing record will remain open for 2 weeks.

The committee stands adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
PAUL A. VOLCKER

Q. 1: You stated that not closing the nonbank loophole and thus allowing a mixture of commerce and banking will result in an increasing concentration of financial and commercial power in our country. Why in your view is that a problem and are there any political implications on such an increased concentration?

ANSWER: Failure to close the nonbank bank loophole will lead to a breakdown in the traditional separation of banking and commerce. As more commercial firms acquire nonbank banks the pressures will grow for banks to also acquire commercial enterprises. That may occur as banks find ways to exploit existing law, or it may come about by actions of state legislatures, or it may develop from Congressional action in response to appeals for competitive equity. Also, as some commercial firms derive advantages from banking services provided by their affiliated banks, their competitors will feel impelled to acquire their own banks. Thus, the nonbank bank phenomenon carries within it the seeds for a significant burgeoning of merger and acquisition activity.

The vision apparently seen by some proponents of nonbank banks is that market forces will eventually sort themselves out into a relatively few major financial commercial conglomerates operating nationwide and internationally as the dominant institutions in banking. When or if that "vision" would fully develop, it seems to be evident the end result could be an inevitably increased concentration of financial and economic power.

The classic problems and dangers of a concentration of economic power are applicable in this instance as well. Concentration is likely to ultimately reduce competitiveness. Equally or more important, commercial firms will inevitably influence their banks to serve their commercial interests in the provision of credit or otherwise, while exposing the banking system to the fortunes of large scale commercial enterprises. In particular, there should also be concern that access to credit for smaller companies and beginning companies could be reduced by the linking of banking to large established commercial enterprises.

Q. 2: If there is any competitive advantage from owning a bank, once one firm in an industry acquires a bank, all the other firms will be forced to acquire or set up there own little "pocket banks."

I am concerned the result will be a proliferation of banks, many operated by companies inexperienced in banking, needlessly and perhaps dangerously increasing the burden on U.S. regulatory and supervisory resources.

Are my concerns justified?

ANSWER: Yes.

The increased supervisory problem as I see it would arise not so much from the increase in the number of banks subject to supervision but rather from the problems associated with the affiliation of banks with commercial firms. From experience in administering the Bank Holding Company Act, we do not believe that it is possible to insulate at all fully the bank from the financial problems of its affiliates.

Although some very strong companies have acquired nonbank banks, there is no reason to think, if this phenomenon develops further, that only strong companies will acquire banks. I would expect to see an impact on the condition of banks and a rise in bank failures as riskier companies and weaker companies acquire banks. Questions will arise as to the nature of the responsibilities of the supervisory agencies to assess the financial condition of the commercial company and to anticipate problems that might have repercussions on the affiliated bank. It should be clear that the banking agencies do not have the resources or expertise to examine the variety of commercial companies that would be affiliated with banks, nor could that be desirable if it could be avoided.

There will be another heavy burden imposed on supervisors. If banks and commercial companies are affiliated, there will be substantial questions about conflicts of interest and strong natural incentives for banks to operate in the interest of their commercial owners or affiliates, including discrimination against competitors or potential competitors of their affiliated commercial company. We can write rules against tying, but in practice, the problems for the regulatory agencies in this area would be very difficult and argue strongly for a continued separation of banking and commerce.

Q. 3: In 1984 there was broad agreement about the need to close the so-called South Dakota loophole, but there was considerable disagreement over how it should be closed. Senator Garn and I favored a provision that would have permitted states to allow their state-chartered institutions to engage in insurance activities provided they engaged in them solely within the chartering state. Senator Dodd's provision, which prevailed in the Senate, provided that even if a state authorized its state-chartered banks to engage in insurance activities, they could not do so if they were a subsidiary of a bank holding company.

In light of the Federal Reserve's denial in 1985 of Citicorp's application to acquire a South Dakota bank to engage in nationwide insurance activities, do you still think Congress needs to enact legislation to close that loophole? If so, which approach to closing the loophole do you favor -- the one originally proposed by Senator Garn and me or the one advocated by Senator Dodd and previously adopted by the Senate?

ANSWER: I believe that it is still desirable and necessary for Congress to clarify existing law and definitively close the so-called South Dakota loophole. While existing law may in certain circumstances be broad enough to cover an egregious case, the Congress should leave no mistake about its policy in this area. The Federal Reserve supports the approach taken by you and Senator Garn -- namely, to limit nonbanking activities to the state that authorized them to that of the Dodd amendment. At the same time we believe that it would be desirable to place some outside limits on what a state would be permitted to authorize for state banks. Some activities, such as unrestricted real estate development or securities investments, plainly involve higher risks and could result in losses to the federal insurance funds. Accordingly, in our judgment the federal government should be able to determine that certain activities are "outside the pale" of what should be a permissible activity for a federally insured institution.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
PAUL A. VOLCKER

Q. 1: During your testimony, you stated that it was not too late to close the nonbank bank loophole because there are only 13 nonbank banks owned by commercial firms that present a problem. If the nonbank bank loophole were closed, would you favor closing it for all nonbank banks or only for those 13 nonbank banks owned by commercial firms?

If we were to allow all but those 13 nonbank banks to remain open, how do we distinguish them from all other nonbank banks? Could you suggest specific legislative language that carves out a method for grandfathering all but those 13 nonbank banks?

If the nonbank bank loophole were to be closed in this manner, would additional restrictions need to be placed on the remaining nonbank banks and if so, what restrictions?

ANSWER: In my testimony, I emphasized the 13 nonbank banks that are owned by commercial firms because I see this aspect of the nonbank bank as the most serious part of the problem. A major purpose of closing the nonbank bank loophole is to set down a framework -- a marker -- for the evolution of the financial system. Fundamental to that evolution is the maintenance of the traditional separation of banking and commerce. If the Congress fails to close the nonbank bank loophole, the number of these institutions that will be owned by commercial firms will undoubtedly expand and the opportunity will have been lost to maintain the separation principle that I believe is so important to an effectively functional financial system.

On the other hand, eventually, I see the possibility of expanding the authority for financial institutions to own banks to include, for example, firms engaging in securities and insurance underwriting. Thus, I see no conflict between maintaining the basic separation between banking and commerce and allowing the grandfathering, with appropriate restrictions, of the approximately 65 nonbank banks that are owned by financial services firms, at least while Congress resolves the larger issue of the appropriate powers of banking organizations.

With respect to your specific question, I would not object to closing the loophole prospectively for all nonbank banks, with grandfathering, if Congress considers this to be appropriate, for existing nonbank banks. The point I was making is that the grandfathering approach is feasible as a practical matter, and not inconsistent with the maintenance of the basic principle of separating banking and commerce, because the number of nonbank banks affiliated with commercial firms is relatively small. Implicit in your question is the suggestion that nonbank banks owned by financial firms be grandfathered but that commercial firms be required to divest their nonbank banks. This seems to me one possible approach.

In answer to the second part of your question, if the Congress desires to require the 13 nonfinancial companies to divest their nonbank banks, the following language could be inserted in section 4 of the Bank Holding Company Act after the general language that grandfathers nonbank banks acquired before the grandfather date:

> Notwithstanding any other provision of this Act, a company that is engaged in activities that are not of a financial nature may not retain for more than two years after the effective date of [the name of the amendatory statute] control of an institution that becomes a bank as a result of enactment of the [the name of the amendatory statute].

The term "of a financial" nature would encompass the broad spectrum of insurance and securities activities, but would not cover manufacturing or retailing activities.

As to restrictions on the remaining nonbank banks, I indicated in my testimony that they should not be able to expand their operations or to operate them in tandem with their nonbanking affiliates. Under the tandem rule, the grandfathered nonbank banks could not offer or market the products and services of nonbank affiliates that are not permissible for bank holding companies or permit the bank's products and services to be offered or marketed through such affiliates. As one method of assuring compliance with these limitations, the grandfathered nonbank bank should not be able to have overdrafts at the Federal Reserve Banks on behalf of their affiliates.

Q. 2: At the conclusion of your oral testimony, you stated that one of the major risks in breaking down the barrier between commerce and banking is the risk to the payment system. Your concern appears to be that the Federal Reserve does not now and does not wish to regulate commercial firms. However, many states now allow foreign firms, many of which are owned by foreign commercial enterprises, to purchase banks. In that situation the Federal Reserve has no knowledge of or ability to regulate the foreign parent. Do you believe this situation raises similar risks to the payment system? If not, why not, and if so, what, if anything, should Congress do about it?

ANSWER: Access by U.S. offices (branches and agencies) of foreign banks to our payments system is a matter we monitor closely because we do not have close supervisory contact with their parent banks. That is why their access to Fedwire is limited now. Their uncollateralized daylight overdrafts on Fedwire cannot exceed a quantity related to their U.S. capital equivalency (essentially a portion of their U.S. assets) and such exposure is monitored closely.

U.S.-chartered foreign-owned banks, with capital in the U.S., are treated like any other bank, and it is true that their foreign parent may be affiliated with a commercial enterprise. (To the best of my knowledge few international banks are owned by a commercial firm.) This situation is necessary in a world of sovereign nations which may have different policies from our own and under a policy of national treatment. In my view, these arrangements for treating domestic subsidiaries of foreign banks the same as U.S. banks represent a reasonable basis for facilitating international trade and capital markets. U.S. banks operate abroad under similar terms and conditions. U.S. authorities, of course, have to be diligent in evaluating the risks in practice, but I think no action is required at this time by the Congress, although I would like to see more equal treatment of U.S. banks overseas.

Q.3 One of the central themes of much of the testimony presented at the hearings dwelled on the tremendous change that we have seen in the financial services industry. One set of such changes is what has occurred in the thrift industry with may thrifts becoming more like banks in issuing certain commercial and consumer loans and carrying checking accounts for individuals. Given the blurring of the line between banks and thrifts, what would you feel the advantages are disadvantages would be of merging our bank and thrift industries?

How would you envision such a merger taking place, and would it involve a merger of the FSLIC and FDIC funds? If so, would the FSLIC still need recapitalization before the funds were merged?

ANSWER: There is no doubt that thrifts and banks have become more alike in recent years. However, I see no need to "force" a merger of the two industries. There is still a desirable place for specialized institutions, and those that continue to, say, specialize in residential mortgage finance might well continue to enjoy special privileges.

However, I do believe that when thrifts give up that specialization -- fail to meet a thrift portfolio test -- this should be taken into account in terms of access to long-term subsidized credit, and, for example, with respect to application of rules on ownership and instate and interstate branching. Regardless of portfolio structure, all insured depository institutions require the same degree of prudential supervision and regulation, and the same attention to asset quality, capital base, and liquidity. That is one of the clear lessons of the last decade. Merger of the insurance funds would be one way of obtaining consistency of treatment (although because of past history, the actual funds would be segregated for a period) and I would welcome Congress exploring that possibility, with others, at a later date.

Q. 3 (3rd paragraph): Given the changes that have occurred in the thrift industry in the last five years, do you believe that the rationale stated by the Federal Reserve Board in 1974 for concluding that the purchase of a thrift by a bank is not "a proper incident to banking" is still valid? If so, what and if not, what rationale would you give for continuing to prevent banks from acquiring healthy thrifts?

ANSWER: No, I do not believe, in fact, the former rationale is still valid. The Board has approved a number of acquisitions by bank holding companies of failing thrifts on the basis that the public benefits of restoring such institutions to health and preventing what otherwise might be serious adverse effects on the thrift industry outweigh any adverse effects resulting from the affiliation. Most of the thrift acquisitions have been authorized by the Board under the provisions of the Garn-St Germain Act, which establishes certain procedures for a bank holding company to acquire a failing thrift. Given the Congressional intent embodied in that statute, the Board has felt constrained to approve acquisitions of thrift institutions only under those provisions.

As you point out, however, there have been very significant changes in the thrift industry in the last few years, including the elimination of the interest rate differential, the expansion of the powers of thrift institutions, and the proliferation of interstate banking opportunities for both banks and thrifts. Nevertheless, there still remain important public policy implications in allowing holding companies to acquire healthy thrifts. Many states continue to limit out-of-state bank holding companies' acquisitions of banks located in those states, and, if they do allow such acquisitions, only by bank holding companies located within certain defined regions. Moreover, allowing the acquisition of healthy thrifts has been opposed in the past by the FHLBB, which also has regulatory jurisdiction over bank holding company healthy thrift acquisitions, because of the adverse implications for the ability of the FSLIC to deal with failing thrifts. In light of these considerations, it would be useful for Congress to provide the Board with guidance in this area.

Q. 4. Much of the delay in clearing checks results from the lengthy process of returning checks that the bank decides not to honor. What steps do you think could be taken and what legal changes would be required to short-cut the return of checks through the entire chain of banks involved in the presentation of the check?

ANSWER: There are a number of different means by which the return of checks could be accelerated ranging from simply permitting returns to be made directly to the institution of first deposit in all jurisdictions to facsimile transmission of the check back to the institution of first deposit. We believe the most feasible approach in terms of making a major improvement in the process at reasonable cost would be to provide for direct return of checks with automation of the return process. These improved arrangements would be feasible if the Federal Reserve is provided with the necessary regulatory authority. This approach would permit earlier availability of deposits at relatively low cost.

Generally, payor banks would be required to effect returns to the institution of first deposit within specified time frames. This would require regulatory authority for the Board to establish these arrangements for all depository institutions for all checks regardless of whether they were collected through the Federal Reserve System. This requirement would necessitate use of transportation methods that would expedite the return of checks rather than use of regular mail which is now used for over 11 percent of returns, slowing the trip back to the institution of first deposit by several days.

A requirement for returns within a specified time period would necessarily require depository institutions to be able to return checks directly to the institution of first deposit and to recoup payment for the check. Although the Uniform Commercial Code of most jurisdictions provides for direct return, three jurisdictions, New Jersey, Wisconsin and the District of Columbia do not provide for direct returns. The Board would need regulatory authority to implement direct returns for all depository institutions.

One means of improving the efficiency of handling return items would be to enclose them in carrier envelopes and have them collected through the forward check collection process -- in effect an automated direct return. In order to encourage payor depository institutions to use carrier envelopes for this purpose, the Board would have to have the authority to create incentives for all payor depository institutions to use this procedure for checks where it would speed the return process.

In addition, other proposals might also be beneficial in speeding the return process. Accordingly, we believe that it is necessary for the Board to be given sufficient regulatory authority in order to speed the check return process for all checks, whether or not processed through the Federal Reserve Banks.

Q. 5: You stated that you do not believe that granting banks the power to market or issue commercial paper, mortgage-backed securities, municipal revenue bonds or mutual funds presents any great risks. What specific steps do you believe should be taken to ensure that the consumer who is encouraged by his banker to, for example, invest in mutual funds, does not mistakenly receive the impression that such an investment is somehow backed by the bank or even FDIC insured?

ANSWER: The Board has long had a policy requiring bank holding companies issuing thrift notes and other debt obligations to disclose prominently that they are not obligations of an affiliate bank and are not insured by the Federal Deposit Insurance Corporation. Moreover, such obligations may not be sold on the premises of an affiliate bank.

In the event that Congress authorizes bank holding companies to underwrite mutual fund shares or mortgage-backed securities, the Board would consider, and in fact has under consideration, a proposal requiring the holding company to provide each of its customers a disclosure statement describing the difference between the underwriting affiliate and its banking affiliates. Such a statement could also indicate that the obligation is not insured by the Federal Deposit Insurance Corporation or an obligation of an affiliate bank. The Board also has under consideration limiting the distribution of prospectuses and sales literature for such securities through offices of an affiliated bank. The Congress might want to consider a requirement of a distinctive name.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GRAHAM FROM
PAUL A. VOLCKER

Q. 1: What impact does the declining dollar have on the U.S. banking system?

ANSWER: Exchange rate changes are probably not a direct major factor at present for U.S. banks, but they do have some indirect implications. While U.S. banks themselves do not typically have significant open positions in foreign currencies, management of foreign exchange portfolios and currency swaps obviously carry risk in volatile markets that must be protected by adequate capital and controls.

Bank customers are, of course, exposed to variations in exchange rates. In'so far as the economic well-being of the banks's debtors and creditors is affected by changes in exchange rates, so too will the banks be affected. For any given change in exchange rates, some individual customers will benefit and some will lose. As a general proposition, a decline in the dollar will tend to enhance the competitive position of U.S. firms and may help, therefore, to enhance the credit quality of U.S. banks' loan domestic portfolios.

On the other hand, the real value of wealth denominated in dollars will diminish with a decline in the dollar, and this may adversely affect banks' customers as well as banks themselves. The decline in the dollar had the incidental effect of making the dollar value of foreign banks' balance sheet positions larger relative to the balance sheet positions of U.S. banks.

Beyond the fundamental positive competitive impact on banks' customers, a decline in the dollar will tend to reduce some of the costs (e.g., labor costs) incurred by U.S. banks relative to those incurred by banks in other countries, just as it improves the competitiveness of nonbank organizations.

Q. 2: On page 10 of your written testimony you discuss foreign experience with "universal" banking systems as justifying greater integration of banking and commerce. What role has their currency exchange rate and fiscal system played in their developing this system?

ANSWER: In my written testimony I said that the experience of other industrialized countries does not justify greater integration of banking and commerce and that, if anything, the trend is toward placing further limits on such linkages. I noted also that ". . . in fact, whatever the formalities of the law, there are few instances in industrialized countries of commercial firms owning important banking institutions" (pages 11-12).

Although I am not an expert on the role played by exchange rate systems or fiscal systems in the evolution of the financial structure of foreign countries, I would be surprised if the experts would say that exchange rate systems played a substantial role, since for most of the period during which the structure of banking systems developed, all countries had essentially similar exchange rate systems. It may be somewhat more likely that variations in fiscal systems could have played a significant role, given the complex interactions between tax policy and the structure of economic enterprise, but on an *a priori* basis, I would be hard put to demonstrate that differences in fiscal systems have had a significant effect on the structure of banking systems.

Q. 3: On page 17 of your statement you discuss the international forces at work in the banking and financial marketplace. Would you elaborate on these "international forces"?

ANSWER: Innovation and deregulation in both international and domestic financial markets in recent years have altered the nature and scope of financial transactions. World financial markets, taking advantage of developments in communications technology and computers, are now much more closely integrated with worldwide trading in some financial instruments on a 24-hour a day basis. The volume of international transactions is enormous, amounting to well in excess of 4-1/2 trillion per day, on average. Major borrowers and lenders have access to a much wider range of markets. Credit flows, especially those involving large, prime borrowers, increasingly are being "securitized," that is, they take the form of direct claims of lenders on ultimate borrowers, rather than using banks as intermediaries. New financial instruments, often not showing up on banks' balance sheets, are evolving and growing in importance. These forces reflect technological change and competitive forces generally and are international in scope.

Q. 4: On page 23 of your written testimony you discuss the supervisory and regulatory discipline that needs to accompany self help by the industry. Do you see this supervisory and regulatory discipline needing to be increased?

ANSWER: I believe that Chairman Gray and the FHLBB have done an excellent job under very difficult circumstances -- an industry with a significant number of insolvent participants and one whose institutions are not used to a high degree of prudential supervision and regulation. As I noted in my testimony, the Bank Board deserves the support of the Congress. I will add that the Congress should avoid constraining the FSLIC/FHLBB's ability to limit abuses, to require realistic collateral and loan valuations, or to require mergers of illiquid or insolvent institutions -- in short to act as a serious and prudent supervisor.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
PAUL A. VOLCKER

Q. 1: In your testimony, you state that the need for additional liquidity for FSLIC is urgent, that the Treasury Plan in the only practical alternative, and that there is no time for delay. What is your view of the U.S. League proposal?

ANSWER: I am not fully informed about the financial aspects of the U.S. League proposal, but my sense is that it's assured financial capacity would be less than the Treasury Plan. Moreover, the public's attitude toward the thrift industry is likely to deteriorate it if appears always to be on the brink of one emergency after another. Thrift regulators should be given the necessary resources to address the problems of the thrift industry. The Treasury Plan appears to be the practical alternative before Congress.

Q. 2: Some trade publications have reported that you believe a merger of the insurance funds may eventually be necessary -- would you please comment on that. If a merger were necessary, do you think it would involve a merger of the regulatory structure? Would thrifts still be required to pay a special assessment or would banks and thrifts be required to contribute equally?

ANSWER: The problem faced by the FSLIC is both serious and will take a considerable amount of time and resources to resolve. As I have stressed, the Treasury-Federal Home Loan Bank Board recapitalization proposal is the practical alternative that is now before the Congress. I would urge, however, that adoption of this alternative should not foreclose our looking at other ways to supplement this approach.

I have suggested that merger of the two insurance funds over a considerable period of time might be one approach that ought to be carefully analyzed. Merger of the two funds would, I believe, have a immediate positive psychological impact in helping to maintain depositors confidence. It would also have the very beneficial effect of placing both banks and thrift institutions under the same broad regulatory framework applying the same accounting, capital and supervisory standards to both types of institutions. This would seem to me to be a very desirable objective and would help to assure that the problems that developed in the past would not reoccur. Although the Federal Home Loan Bank Board has made major strides forward, more remains to be done and the merger of the two funds could be a major catalyst for these developments. Obviously, the application of accounting, regulatory and capital standards now applicable to banks would have to take place over a period of time.

Similarly, full integration of risk assumption would also have to take place over a period of time. One approach might be for the FSLIC to remain for some period as a separate accounting entity within the FDIC and with thrift institutions paying higher premiums into this facility: only after a period of time would there be full risk sharing and equality of premium charges.

In response to your question, I mention this idea only as input into your thought process as an additional perspective to take into account after the necessary immediate action is taken to strengthen the FSLIC as proposed in the Treasury-FHLBB proposal now before the Senate.

Q. 3: In your testimony, you indicate that common ownership of businesses means common direction and further state that the fortunes of one business unit rest on the performance of the others. This may be true for a traditional bank holding company where virtually all the assets are bank assets -- but isn't it much less true for more diversified firms who routinely sell off businesses in whole or in part that do not perform as expected -- such as American Express?

ANSWER: In my view, any form of holding company implies common direction by holding company management. This is particularly true in the case of companies that own banks, where confidence is essential to success. Banks must have the confidence of their customers who entrust them with liquid assets, seek secure use of the payment mechanism, and desire dependable credit lines. Consequently, bank customers are understandably sensitive to the strength of their bank and the reliability of their management. Our experience is that depositors and other funding sources can and do react to negative news regarding affiliated units that the customers clearly perceive to be part of the bank entity (most often with the same name). Again our experience is that in response, bank and holding company managements tend to behave as if the affiliated companies are one entity in order to protect the name and position of all the affiliates. I do not see why this situation would change in the case of a large diversified firm that owns a relatively small bank. Problems in the affiliate would still have a potential impact on its bank and, consequently, on the federal safety net as well. Moreover, I see nothing in current proposals for eliminating the banking/commerce barriers that would prevent the bank acquired by a diversified firm from being a very large bank, absolutely or relative to the business of the firm. Care would have to be exercised to assure that the resources of the bank would not be used to support troubled affiliates. For many reasons, including the risks to banks from affiliated firms, I do not think we should take chances where the combination of banking and commercial firms is involved.

Both bank holding companies and more diversified businesses can and do sell affiliates, and I expect, as you suggest, that is more common for the diversified firm. But I do not think that changes the analysis. You are aware, for instance, the American Express infused large amounts of capital in its insurance affiliate in time of need. It is a strong company, and could afford to do so. Baldwin United apparently drew on different parts of its corporate structure to support the whole, until it all went bankrupt, involving its insurance company as well as other parts.

Q. 4: In reading your testimony, I was surprised to see references and arguments leading toward a financial services holding company. Not only do you endorse commercial paper, municipal revenue bonds, and mortgage-backed securities, you also support investment companies being able to affiliate with a full service bank. Isn't this the first time you have testified that you recognize the unfairness of a legislative proposal that would grant bank holding companies mutual fund authority while requiring investment companies to divest their nonbank banks?

ANSWER: Under my proposal, bank holding companies would be permitted to own a firm that underwrites and distributes mutual funds. The effect of this authorization would also be to allow a firm that distributes and underwrites mutual funds to own a bank. This is not merely a theoretical concept -- as a practical matter there are a considerable number of mutual fund underwriters that would be in a position to take advantage of this opportunity.

This position is entirely consistent with the position that I have taken for some time. The Federal Reserve cooperated with the Treasury Department in drafting the bill that was introduced as S. 1609 in 1983 which advocated that bank holding companies be permitted to engage in a considerable number of financial activities, including mutual funds. The effect of the bill would have been to permit bank holding companies to own these types of financial services firms and vice versa.

While the four securities powers you mention have long been supported by the Board, my testimony clearly suggested

Congress ought to explore further "financial" powers as well at a later day. None of these would violate basic separation between banking and commerce. Moreover, it is especially important because of the identity of interest between a bank and its affiliate companies that the company owning this institution operate within a prudential framework to assure maximum separation between the bank and other financial companies, and that the enterprise as a whole be operated in a safe and sound manner.

Q. 5: Later you strongly recommend that the committee consider expanding bank holding company activity to insurance and even corporate underwriting. You point to the overseas market -- particularly London -- and the ever increasing trend toward securitization. If after study the Congress were to decide to further extend the product authorities of bank holding companies, is it fair to extend the logic of the financial service holding company concept to those new authorities?

ANSWER: I do not know what is "the logic of a financial service holding company." But, as I pointed out in answer to your previous question, the proposals that we have made for expansion of bank holding company powers and services has inherent in it a two-way street -- if a bank holding company can *e.g.* buy an insurance company, an insurance company should be able to buy a bank -- provided, in either case that all the activities of the combined firm are appropriate for a bank holding company. We strongly recommend that Congress expand the powers for bank holding companies to allow them to compete more effectively and at the same time this will have the effect of permitting other types of providers of financial services to own banks, all within the framework that we believe is essential to maintaining the stability and safety and soundness of the financial system and to avoiding conflicts of interest and concentration of resources.

Q. 6 With regard to the so called nonbank bank -- do you believe that the Congress should deal with the nonbank bank and the so-called nonthrift thrift at the same time?

ANSWER: Yes. It makes little sense, in my opinion, to close the nonbank bank loophole without addressing the problem the nonthrift thrifts. If Congress closes the nonbank bank loophole without acting on the nonthrift thrift question, this would encourage companies seeking to affiliate with depository institutions to gain access to the payments system or for other reasons to acquire a thrift institution through the current exemption provided for unitary savings and loan holding companies. I believe this loophole can be closed in a way that maintains the option for diversified companies to continue to own "free standing thrifts" heavily engaged in financing housing, while requiring those that wish to engage in a broader range of financial services activities to conform to the same prudential and other rules that are applicable to their competitors in the same businesses.

Q: 7: Over the past fifteen years there appears to have been a distinct change in the profitability of the basic wholesale banking business as noted in the report recently completed by the Federal Reserve Bank of New York. I would be interested in your comments on the future viability of banks referred to in that report.

ANSWER: More intense competition from foreign banks, from nonbank suppliers of credit, and from the securities markets have all placed the profit margin of banks, particularly large wholesale banks, under more pressure. However, I do not read the New York Bank report as reflecting a dramatic permanent shift in profitability. In particular, loan losses associated with sectoral difficulties or special situations (developing country debts, agriculture, real estate, and energy) have played a more significant role in constraining earnings. As a general matter, these problems are credit risks associated with the traditional banking business that will be absorbed and adjusted over time. Independent of these banking credit problems, wholesale banks could benefit from additional powers, such as underwriting certain types of securities. The new powers that we have supported would represent a prudent regulatory response to a change in the competitive environment. I do not, under this approach, fear for the viability of banks, large and small.

There is another area where progress must be made to assure a more competitively fair environment for U.S. and foreign banks -- capital adequacy standard. More uniform international capital standards, such as developed in the recent Bank of England-Federal Banking Agencies agreements, are an important step in a more equitable institutional competitive environment. Following the direction of Congress contained in the International Lending Supervision Act, I think we are beginning to make real progress in this area.

Q. 8: I believe that about 15 years ago, 7 out of the top 10 largest banks in the world were U.S. banks and today only one of the top 10 banks in the world is a U.S. bank. I'd like your views on why the growth of U.S. banks relative to the growth of other banks has slowed down so dramatically.

ANSWER: One very important factor over the past two years has been the strong rise in the yen and other currencies, relative to the dollar, which has made the dollar value of foreign banks' balance sheets grow much faster than that of U.S. banks. This, of course, reflects fundamental problems arising from our trade and budget deficits, and the surpluses of other countries, and does not imply any lack of competitiveness of United States banking institutions.

But there are other factors that should be taken into account. Lists of the top banks in the world are dominated by banks in countries with highly concentrated banking systems -- Japan and France -- which are not necessarily a model for us. Historically, U.S. banking organizations have certainly been among the more aggressive internationally, but, more recently, U.S. banks have been paring back their balance sheets in order to enhance their rate of return on assets and to improve their capital positions. Meanwhile, more foreign banks have been increasingly aggressive in international money markets. While precise comparisons of capital standards across countries are difficult, it seems that not all foreign banks are subject to capital standards as stringent as those faced by U.S. banks. The Federal Reserve has been actively engaged in an effort with other supervisory authorities to coordinate international capital standards; a major step in that process was made in the recent joint risk-based capital proposal by the Federal Banking Agencies and the Bank of England.

In general, I believe that we should be primarily concerned with the strength and quality of our banks, and strong banks will be able to compete effectively and aggressively in international markets.

Q. 9: As you know, several U.S. money center banks have been in the business of underwriting corporate securities in Europe for a number of years. And as far as I know, they have done so without any particular problems or threats to the safety and soundness of the parent institution. If this is true, what is wrong with letting them underwrite corporate securities in the U.S. market?

ANSWER: It is true that bank affiliates abroad are permitted to underwrite corporate debt issues in those markets in which local banks may do so, although there are severe limitations on their authority to underwrite equity issues. Their success in underwriting corporate bonds is certainly a factor that should be taken into consideration in evaluating legislation to permit such activity in the United States. However, the size of U.S. capital markets, the number and nature of potential issuers and bank underwriters, and the competitive environment, all need to be evaluated. I believe that consideration of such an expansion of underwriting authority should be part of a broader examination of bank holding company powers and services that is planned to follow Congressional consideration of the legislation that is now before the Senate Banking Committee.

Q. 10: The United Kingdom and Canada have recently taken substantial steps toward protecting the viability of their securities and capital markets by undertaking a significant restructuring of their financial system. Japan is currently discussing taking similar steps. Shouldn't the U.S. be undertaking the same major restructuring so that in the long run its capital and securities markets don't get left behind?

ANSWER: Obviously the success of the British and Canadian initiatives remains to be seen, but they certainly, in large part, represent an effort to "catch up" to the efficiency and competitiveness of the United States rather than the reverse. But that does not mean some of the steps taken abroad may not be suggestive of desirable changes here. In general, the thrust of our recommendations move in a similar direction. However, I must emphasize that both here and abroad, a variety of considerations are at state. Thus, bank holding company powers must take account of the safety and soundness of banks, conflicts of interest, the viability and safety of the payments mechanism, and the proper limits on the reach of the federal safety net. These issues should not be overlooked in an effort to enhance or protect the competitive position of a particular set of financial institutions. Clearly, there are financial service areas in which banking powers can be increased consistent with these concerns. The Federal Reserve has since 1982 supported, with the Treasury, limited underwriting, real estate, and insurance powers and continues to urge Congress to enact such legislation. I would again like to emphasize that those powers and services that go beyond those that are not before the Senate should be the subject for review, analysis and legislative action as soon as possible after the enactment of pending bills.

Q. 11: I would like to return for a moment to the European underwriting affiliates already owned by many of our largest money-center banks. Isn't it possible that if we don't make our regulatory system more flexible, many of these money-center banks will have no choice but to move an increasingly larger percentage of their activities abroad, thus costing the u.S. jobs, capital and tax revenues?

ANSWER: Clearly, incentives could be provided in that direction, which is one good reason this whole area should be reexamined.

Q. 12: Earlier, reference was made to the major restructuring of financial markets undertaken by the United Kingdom and Canada which they view as necessary to protect jobs and increase competition. Over the years there has been an influx of foreign banks to New York, the major domestic financial market, which has improved New York's economy. Isn't it likely that significant deregulation in the U.S. will mean more jobs in the U.S. financial services sector as foreign institutions increase their presence here and less loss of jobs for U.S. banks?

ANSWER: I have not personally heard the "jobs" rationale presented as important justification for the changes in the United Kingdom and Canada. In any event, I do not believe a kind of international competition in laxity in a search for jobs can provide a sound rationale for regulation of banks and financial markets. The changes should be made on their own merit. As I have already stressed and as the premise of your question recognizes, U.S. markets are highly competitive. A large amount of financial intermediation will be done here and the companies that provide that service will employ large number of people. Your acknowledgement that large numbers of foreign banks have been attracted here is ample recognition of this fact. From an employment perspective, it does not matter who provides the service -- someone will hire people to provide the service. If there are artificial incentives to move jobs based on differences in regulations, they should be examined and dealt with in ways consistent with safety and soundness, the need for competition and the like.

Q. 13: The banking industry, including the small banks, is facing increased pressure from competitors which have greater flexibility to respond to a dynamic market with products like the securitization of car loans and the securitization of consumer credit receivables. Do you see any way in which we can keep our banking system healthy and competitive without substantially altering the current regulatory structure to permit full competition among the financial services providers?

ANSWER: Banks need no new powers to securitize their loan portfolios. Banks have sold loans to each other (syndication) for generations, to nonbank institutions through private placements managed on their own for decades, and to the general public through unaffiliated underwriters more recently. The question of whether they themselves should underwrite such issues for public distribution is, indeed, a matter I think should be reviewed.

Banks compete and are competed with in virtually every credit market. The issue is the degree to which new powers are consistent with both safety and soundness of banks and the banks' support by the federal safety net. We do not believe this objective can be achieved by dismantling the barriers that have separated banking and commerce or by undermining them through permitting the exploitation of loopholes. We should begin by reaffirming that basic element in the structure of banking in this country. With this task done we should undertake the serious exploration of the necessary additional steps to improve competitiveness and service to consumers consistent with necessary rules to assure the fairness and stability of the system as a whole. But I think you substantially overstate the issue if you suggest the banking system cannon remain "healthy and competitive" without bank holding companies exercising all financial powers. That may or not be a good idea, but I simply know of _no_ evidence that suggests the fate of the entire banking system rests on exercising every "financial" power. In fact, what I see in the market place is some financial conglomerates freely stepping back from participating in some sectors of the market (_e.g._, American Express from insurance, Merill Lynch from real estate brokerage and Beneficial from nonbank banking).

Q. 14: As you are well aware, many issues concerning "conflicts of interest" have been raised over the years going all the way back to the Glass-Steagall Act. Is there any evidence that the domestic underwriting and dealing activities currently engaged in by banks has led to any concerns about safety and soundness of those banks or the banking system?

ANSWER: As you know, member banks have been permitted under the Banking Act of 1933 to underwrite U.S. government securities, certain municipal and state obligations, and certain other obligations specifically authorized by Congress. I know of no evidence to indicate that these activities have led to important adverse effects on the safety and soundness of the banks or bank holding companies involved. This experience accounts, in part, for the Board's support for granting bank holding companies authority to underwrite municipal revenue bonds and mortgage-backed securities. These are, of course, securities for which possibilities of conflict of interest are much more limited than, say, for corporate securities. As you no doubt are aware, bankers were pilloried (and sometimes indicted) for conflicts of interest in the early 1930s.

Q.14 (second question 14): The capital raising mechanism in this country is becoming increasingly centered in New York. Wouldn't it make sense to improve the capital-raising abilities in other areas of the country by permitting the banking system, under proper regulation, to compete in this market?

ANSWER: Regional securities firms without a New York presence survive and prosper in the United States and, in general, regional disparities in access to markets have substantially diminished over several decades wherever major dealers and underwriters are headquartered. In any event, I warmly support the ability of regional or local banks with the capacity to do so to engage in the same securities activities I recommended for any bank holding companies.

Q. 15: Does the high degree of concentration which currently exists within the investment banking industry and excessive profits earned by those firms, cause any concern that there needs to be greater competition in those markets? Wouldn't banks and other financial services providers be natural entrants in that market? If U.S. banks are prohibited from entering, isn't it more likely that instead of losing market shares to U.S. banks, securities firms will instead lose shares to foreign securities firms and foreign financial intermediaries?

ANSWER: There is no doubt that a few large U.S. banks are attracted to what they perceive as significant profits in securities underwriting, and investment bankers have aggressively sought to protect their market from bank competition. Much of the recent profits of investment banking firms have apparently been the result of the merger and acquisition business, a relatively recent phenomenon and a business from which banks are not prohibited by law or regulation. Another large portion of their profits come from trading in United States government securities, an activity in which banks are major participants. My understanding is that corporate underwriting, and particularly corporate debt underwriting, accounts for a diminishing share of the profits of investment firms. Mortgage-backed bonds, commercial paper, and revenue bonds are growing and profitable market segments.

In the New York Reserve Bank study to which you referred earlier, there is an interesting analysis of the potential for profit in bank entry into corporate underwriting (at pp. 336-339). One item pointed out is the profits from corporate underwriting, even if maintained under bank entry, could significantly affect the profits of relatively few banks. The commercial banking industry is simply many times larger than the investment banking business.

Finally, as I have pointed out, I see no evidence that U.S. capital markets are uncompetitive and that there is any serious risk that U.S. firms will lose market share to foreign competitors because these markets permit the linking of banking and securities firms. On the contrary, in Germany the Monopolies Commission and the academic advisors to the Economics Ministry complain that German capital markets are stifled and stunted because the large banks dominate the securities markets, but are more interested in lending to established companies than providing equity to innovative start-up firms.

Q. 16. In your testimony, you indicate that it is not too late for the Congress to close the nonbank bank loophole. You specify that you have narrowed your view to 13 companies. What are the names of the parents of those nonbank banks?

ANSWER: The parents of the 13 nonbank banks referred to in my testimony are listed below:

	Parent Company	Bank
1.	Gulf & Western Corp., New York, New York	Associates National Bank, Concord, California
2.	Household International Corp., Prospect Heights, Illinois	Valley National Bank, Salinas, California
3.	McMahan Valley Stores, Carlsbad	Western Family Bank, N.A., Carlsbad, California
4.	J.C. Penny Company, Inc., New York, New York	J.C. Penney National Bank, Harrington, Delaware
5.	Textron, Inc. Providence, Rhode Island	Avco National Bank, Irving, California
6.	Sears, Roebuck & Co. Chicago, Illinois	Greenwood Trust Co., Greenwood, Delaware

7.	Sears, Roebuck and Co. Chicago, Illinois	Hurley State Bank, Hurley, South Dakota
8.	ITT Corporation, New York, New York	Lyndon Guaranty Bank of Ohio, Columbus, Ohio
9.	ITT Corporation, New York, New York	Lyndon Guaranty Bank of New York, Greece, New York
10.	Florida Power & Light Company, Philadelphia, Pennsylvania	Bay Loan and Investment Corporation, East Greenwich, Rhode Island
11.	Montgomery Ward & Co., Chicago, Illinois	Clayton Bank & Trust Co., Clayton, Delaware
12.	Archer-Daniel-Midlands Company, Decatur, Illinois	Eagle Bank of Macon County, Forsyth,
13.	General Electric Corp., Westport, Connecticut	The Monogram Bank Blue Ash, Ohio

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
PAUL A. VOLCKER

Q. 1: In his testimony, Undersecretary Gould states that a comprehensive bill would include:

> "Strengthening the safety and soundness of our financial system so that the public will continue to have confidence in the stability of our financial institutions."

How would granting banks additional powers that expose them to greater risks accomplish the goal of maintaining "confidence in the stability of our financial institutions"?

ANSWER: The underwriting powers which we support as part of recent legislative proposals -- municipal revenue bonds, mortgage-backed securities, commercial paper, and mutual fund shares -- do not involve unusual risk or involve conflicts of interest or concentration of resources. They are entirely consistent with the current authorization for underwriting U.S. government securities, general obligation bonds and other specifically provided for agency securities. Our experience with bank underwriting of these securities has been entirely satisfactory. Allowing bank holding companies to provide these services will improve service to the customer and lower costs of financing. We believe that service provided in this manner is consistent with confidence in banking organizations and may strengthen them financially by providing a more diversified source of earnings. We have had the same considerations in mind in making judgments about other products and services. But the question of the benefits and cost of expanding the authority of banking organizations to provide these additional services in some instances need further evaluation and I urge the Senate to begin this evaluation as soon as you have completed the task of enacting pending legislation.

Q. 2: The Baker Plan to promote growth in debtor countries requires the extension of credit from U.S. commercial banks if it is to succeed. If banks are permitted to engage in security underwriting activities which create new profit centers for them, then won't they be most reluctant to lend the funds to debtor nations? Therefore, doesn't Secretary Baker's advocacy of an expansion of securities powers to banks undermine the Baker Plan?

ANSWER: I see no reason to expect that permitting banks to engage more broadly in underwriting of securities would induce them to make significant changes in their international lending activities. If there is an influence, greater diversification may reduce reluctance to lend.

Q. 3: Considering the highly concentrated nature of the Japanese banking industry and the symbiotic relationship between the Japanese government, Japanese corporations and Japanese banks, isn't the real surprise that it has taken the Japanese so long to become 4 of the 5 largest banks in the world rather than the fact that they have achieved this status? Has the size of these foreign institutions resulted in placing American institutions which compete in the international markets at a competitive disadvantage?

ANSWER: The growth and size of Japanese banks mainly reflects the relatively concentrated nature of the Japanese banking industry, the large amounts of savings generated by the

Japanese economy, and the recent rise in the value of the yen (which raises the dollar value of yen assets on Japanese banks' balance sheets), as well as the competitive behavior of Japanese banks in international markets. While the size of Japanese banks earns them top ranking in lists of the world's largest banks -- and, indeed, that may have motivated some of their behavior -- their size in itself does not give them a competitive advantage. The U.S. money-center banks and the large banks in other countries surely are big enough to compete effectively, and do so.

Other factors may indeed work to the competitive disadvantage of U.S. banks. For instance, the capital standards to which U.S. banks are subject may be more stringent than those facing some foreign banks: the Federal Reserve has been working actively to coordinate capital standards across countries in part for this reason, and significant progress recently has been made in that direction.

Q. 4: Isn't the real problem with competitiveness the failure of banking institutions to offer credit at interest rates competitive with the rates borrowers must pay to the holders of their commercial paper?

ANSWER: Yes, that is part of the problem -- the inability of banks to be able to offer notes that are lower than the commercial paper market. Naturally, the bank, which used to make loans to the commercial paper borrower wants to be able to continue to service its former client who now does his commercial loan borrowing in another form -- commercial paper. Done in the right way -- and I believe there is no reason it cannot be done in the right way -- I see no special risk to a bank from underwriting commercial paper. Technically the risk is smaller.

There are many reasons why banks are unable to offer as low rates are available in the commercial paper market. The short answer is that the commercial paper market cuts out much of the role of the middle man. More technically, the investor in commercial paper has assumed the credit risk usually absorbed by the bank. Obviously, the issuer of commercial paper must be of the highest credit rating (or a bank has had to guarantee the credit for a fee that encompasses the credit risk only) and not the cost of funding (i.e., of obtaining the funds to finance a totally riskless credit). Thus, an increasing number of low-risk borrowers have chosen to by-pass banks or pay them a small fee for credit risk.

Q. 5: Chairman Volcker you have often warned this committee about the explosion of corporate debt in this country, wouldn't this problem be exacerbated by allowing commercial banks the ability to underwrite corporate debt?

ANSWER: I do not believe so: it would primarily shift to some extent the focus of the underwriting business, so long as banks maintained prudent standards. In that respect, I have no reason to believe that bank standards would be less, in general, than those of investment banks.

Q. 6: If a bank holding company is allowed to engage in securities underwriting and this is an appropriate banking activity, and you believe that commercial and banking should remain separate, do you also feel that no commercial concern should be able to acquire a firm that engages in underwriting activity? If commercial entities are allowed to acquire securities firms, which you have characterized as an appropriate banking activity, then why shouldn't commercial firms be allowed to engage in other banking activities? How do you draw the line?

ANSWER: You asked me whether in view of my support for the separation of banking and commerce whether I would also support the combination of commercial and underwriting firms.

I want to emphasize that the fundamental premise of my support for the separation of banking and commerce is the special role that banks play in the economy as the custodians of liquid savings, and as operators of a secure and reliable payments mechanism and as impartial decision makers in the granting of credit, as well as because of their special role in the implementation of monetary policy. It is because of this role that Congress has provided a measure of federal support through federal deposit insurance and Federal Reserve credit facilities that other industries do not enjoy. It is because of these characteristics that a measure of federal regulation is necessary and appropriate. Experience has shown over time that in order to avoid conflicts of interest, concentration of resources and other adverse consequences that could impair the important role for banking institutions in the economy that I have described, it is both prudent and desirable to maintain a broad separation between the users of credit and the commercial banking system.

This explains my reasons for strongly recommending the continued separation of banking and commerce. You also asked whether there should be a similar separation between securities underwriting and commercial firms. In my judgment, as a matter of prudence and good practice, this would seem to me a desirable practice, but I have not raised it as a question of law or regulation. The securities industry, while important, does not have the same crucial role in so many areas of the economy as banking and it is not the beneficiary of the same level of federal support. Therefore, I do not see the same need for requiring separation between commercial firms and securities underwriters, although I could see good reason why a securities underwriter would want, as a matter of prudence, to maintain its objectivity and independence by remaining unaffiliated with firms that are the potential users of its services.

Finally, you asked if commercial firms are allowed to buy securities underwriters why shouldn't commercial firms be allowed to engage in other banking activities. I believe the answer to this question flows directly from my introductory remarks in answering this question: banking is special, it is supported by the federal safety net, and needs to remain independent from the consumers of credit and other banking services.

You point out that it is difficult to draw lines. I would agree that line drawing in this area is very difficult. We should err on the side of avoiding the extension of the scope of federal regulation, but to my mind there is a clear and compelling case, justified by long experience, for maintaining a measure of federal regulation of the ownership of banking organizations. I believe it is reasonable that the line be drawn between banking and commercial firms.

Q. 7: On page 12 of Undersecretary Gould's testimony, he states that the Treasury would support expanded products and services for banks through separately capitalized facilities. What specific safeguards would you suggest to insure that the same self-dealing and conflicts of interest that were revealed in the hearings culminating in the Glass-Steagall Act? For example, should a bank's securities subsidiary be permitted to underwrite or securitize the credit extended by the parent bank?

ANSWER: As you know, the Board currently has under consideration, applications by a number of bank holding companies to underwrite and deal in, to a limited extent, municipal revenue bonds, mortgage-backed securities, and commercial paper. In connection with those applications, the Board has under consideration whether to impose a number of conditions designed to address the problem of self dealing and conflicts of interest that were of concern to Congress in 1933 and that lead to the enactment of the Glass-Steagall Act.

Among the conditions the Board is considering are the following:

1. A bank affiliate should not provide a standby letter of credit or other credit facility for securities underwritten by a securities affiliate or extend credit to a customer to purchase such securities or to an issuer of such securities for the purpose of the payment of principal or interest on the securities.

2. The underwriting affiliate should disclose the difference between it and its banking affiliates as well as any lending relationships between the issuer and the affiliate, and should refrain from engaging in advertising or entering into agreements suggesting that an affiliated bank is responsible for its underwriting obligations, and from distributing prospectuses and sales literature through an affiliated bank or offices of the bank.

3. Employees of an affiliated bank should not express an opinion with respect to the advisability of purchasing securities underwritten by an affiliate unless an appropriate disclosure of the affiliate's interest in the securities is made and a bank affiliate should not purchase in a fiduciary capacity for accounts over which it has investment discretion securities underwritten by an affiliate during the period of the underwriting or selling syndicate, unless the purchase is specifically authorized by the parties in interest or otherwise by law.

4. An underwriting affiliate should not underwrite securities to repay a loan by a bank affiliate to the issuer, and should not underwrite securities issued by its bank holding company affiliates.

5. The holding company and its affiliates should not purchase for their own account securities underwritten by an affiliate, and other transactions between the bank and an underwriting affiliate, or with persons in which the underwriting affiliate is a participant or has a financial interest, should be on an arm's length and on terms no less stringent than those applicable to unrelated third parties.

6. The bank affiliate should not provide information to the underwriting affiliate except as required by law.
7. The underwriting affiliate should not have a name that is similar to that of an affiliate bank.

If the Congress authorized bank holding company underwriting of mortgage-backed securities, commercial paper, municipal revenue bonds and mutual funds, the Board would consider whether any of the above conditions or others would be necessary. The Board would have the authority and the obligation to adopt any conditions necessary to assure that the new activities are conducted in a safe and sound manner. In this connection, it is useful to point out that under Glass-Steagall banks have for some time been underwriting general obligation bonds, United States government securities and a number of other types of obligations without adverse effects, especially conflicts of interest. This experience would be taken into account as one element in the decision making process that would go into the formulation of the specific rules applicable to the new underwriting authorities. The particular question about whether a securities subsidiary should be permitted to underwrite credit extended by an affiliated bank is precisely one of the issues Congress should address in considering corporate underwriting, which is not part of the present proposals.

Q. 8: Many critics of the Glass-Steagall Act suggest that banks have been squeezed out of their traditional sources of revenue and therefore need to expand into the areas of security underwriting. This argument seems hollow in light of the Wall Street Journal article demonstrating the profitability of these institutions through their traditional lines of business. Incidentally, the most profitable banks are those that are most vociferously arguing for the expansion of bank powers. Would you comment on the internal inconsistency in this argument?

ANSWER: As noted in my answer to your question 4, bank profits have been under pressure from customers issuing securities rather than borrowing from banks. In the aggregate, bank profits -- including those of large banks -- have been rising over the last year or so, but margins remain under pressure. But, in my view, revisions of Glass-Steagall should not in the end turn primarily on implications for bank profits -- and of the thousands of banks, corporate underwriting would be important to only a very few -- but on public benefits vs. banking risks. In my view, some additional underwriting powers are consistent with public benefits, with little or no increase in bank risk and would also be consistent with maintaining bank profitability.

Q. 9: On page 15 of Undersecretary Gould's testimony, he mentions that "outdated and unfair restrictions on the u.S. banking industry are hindering its ability to complete in global markets." This statement conflicts with your statement at the January 21, 1997 hearing that U.S. banks are on the "cutting edge" of foreign competition. Can you explain the difference in these two positions and to what specific "outdated and unfair restrictions" are you referring.

ANSWER: U.S. banks are able to offer many of the same services and to market many of the same products abroad that foreign banks can provide. Indeed, U.S. banks have been among the most innovative in developing new instruments and products in many foreign as well as domestic markets. At the same time, U.S. banks can offer any services or products in the United States that foreign banks can offer (except for some relatively minor instances of grandfathering).

U.S. banks may, however, be somewhat hindered in the short run in competing for business by our standards for capital adequacy may be more stringent than some of those abroad. International comparisons of capital standards are exceedingly difficult to make. Nevertheless, major efforts have been underway to address this problem, not by sacrificing the adequacy of U.S. banks' capital, which should be strengthened, but rather by raising the capital standards for banks internationally. A significant step in this process of international coordination of capital standards is represented by the recent joint proposal by the Federal Banking Agencies and the Bank of England for a risk-based capital measure.

I cannot respond for Undersecretary Gould as to what restrictions he has in mind, although he may be referring in fact to such matters as branching or interstate restrictions that reduce the domestic base of U.S. international banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM PAUL VOLCKER

International Coordination of Bank Regulatory Standards

On January 8, 1987, the United States and Britain announced a pioneering regulatory agreement that will impose on British and American banks almost identical standards for the levels of capital they must maintain. It is my understanding that the Fed has been talking to Japanese officials about a similar agreement with Japan.

Is that correct? And, if so, what other countries are you talking to and what can you tell us about those discussions?

In addition to capital standards, what other uniform standards are being discussed? Are you discussing issues of market openness, bank supervision, national treatment, and financial practices?

Answer: Prior to announcing the proposed risk-based capital framework, discussions were held with banking supervisors from the G-10 group of countries, including Japan, to inform them of the contents of the proposed agreement between the U.S. bank regulatory agencies and the Bank of England. Responsibility for conducting these meetings was shared by the Federal Reserve and the Bank of England, with the Federal Reserve holding initial discussions with representatives from Japan and Canada, and the Bank of England meeting with representatives from the European members of the G-10 group.

One important objective of the U.S./U.K. proposal is to foster greater convergence in the assessment of capital adequacy on an international basis. Thus, it is our hope that banking supervisors in the major industrial countries will examine the proposal with a view toward bringing their policies--to the extent possible--into alignment with emerging international norms for internationally active banks. Because of significant differences among some countries in banking, accounting, and supervisory and regulatory practices, progress toward achieving greater consistency on an international level may be gradual and involve difficult and complex discussions. Nonetheless, the Federal Reserve, together with the Bank of England, is committed to cooperating with other supervisors, and working through the Committee on Bank Regulatory and Supervisory Practices ("Basle Supervisor's Committee"), to encourage the adoption of appropriate and consistent capital standards for international banking organizations.

The proposed U.S./U.K. Agreement owes much to the groundwork laid by the Basle Supervisor's Committee, the European Community's Banking Advisory Committee, and other international organizations which have devoted considerable resources in recent years to the discussion of the coordination and harmonization of supervisory policies and practices among the G-10 countries. The Basle Supervisor's Committee was established to promote high standards of international banking practice and banking supervision, and is the principal forum through which banking standards and supervisory practices are discussed by the banking supervisors of the major industrialized countries. In recent months, the Committee has discussed, in

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Riegle -- Volcker

addition to capital standards, issues such as off-balance sheet exposures, interest rate risk, securitization and other financial innovations, and the globalization of financial markets.

The United States has long followed a policy of open markets and national treatment with respect to banking operations. In carrying out its ongoing responsibilities, the Federal Reserve meets with foreign supervisors and central banks and, in the course of these meetings, seeks to encourage foreign countries to pursue similar policies of openness and fair treatment. Our commitment to national treatment has led us to allow foreign banks to operate in U.S. financial markets on an equal footing with domestic banks and has contributed to making U.S. financial markets among the largest and most efficient in the world. Consistent with this policy, the Federal Reserve has also permitted foreign-owned firms to serve as primary dealers in U.S. government securities.

In taking these actions, the Federal Reserve has affirmed its continuing commitment to national treatment and open markets. Nonetheless, we believe that such actions must be viewed as a catalyst for complementary actions by foreign countries. In this regard, we have stressed in our discussions with foreign countries that our commitment to the policy of national treatment depends on a steady flow of complementary and consistent policy actions in key markets abroad.

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Riegle -- Volcker

With respect to Japanese financial markets, progress has been made on a variety of fronts, and indications are that the Japanese authorities are committed to taking further actions to open their markets. In particular, we understand that the Ministry of Finance will now consider applications from foreign securities firms to conduct business in Japan, and that the Ministry will support a greater allocation of underwriting shares in Japanese Government securities for foreign firms. In this connection, Japan's Ministry of Finance recently announced its decision to allow U.S. commercial banks to operate securities subsidiaries in Japan. U.S. banks will, of course, have to apply for licenses for this purpose. In addition, we understand that the Ministry will consider easing the requirements for participation in medium-term auctions of Japanese Government bonds. We are hopeful that progress along these lines will continue.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ROBERT L. CLARKE

Q. 1. On page 9 of your written statement, you contend that "the decision in the Dimension and U.S. Trust cases recognizes that the nonbank banks are legitimate financial institutions," and that the preliminary injunction issued by the Florida court in IBAA vs. Conover is therefore inappropriate.

My reading of the Dimension and U.S. Trust cases does not indicate that the courts were giving any blessing of legitimacy to nonbank banks. The Supreme Court in the Dimension case stated, "Without doubt there is much to be said for regulating financial institutions that are the functional equivalents of banks". It said also that the definition of banks in the Bank Holding Company Act would not cover nonbank banks and added, "If the Bank Holding Company falls short of providing safeguards desirable or necessary to protect the public interest, that is a problem for Congress, and not the Board or the courts, to address."

The 11th Circuit said in the U.S. Trust case, "We recognize that by our holding today, we sanction a result that clearly frustrates the Congressional purpose expressed in the Douglas amendment".

Would you agree that it is an overstatement to call something "legitimate" when that thing owes its existence solely to a loophole in the law that allows it to get around public policy prescriptions? Isn't it time for the Congress to act on this matter?

A. 1. No, I do not agree that it is an overstatement to refer to nonbank banks as legitimate. Except for the purposes of the Bank Holding Company Act (BHCA), nonbank banks are, in all other respects, banking institutions. The so-called nonbank banks are banking institutions, chartered under the same state or national authority as any other bank. They are governed by the same laws and regulations as other banks and are subject to the full scope of the primary supervisor's regulatory, supervisory and enforcement authority. In the case of state nonmember banks, they also are subject to FDIC supervision and regulation. Although nonbank banks allow holding companies geographical expansion opportunities that are not otherwise available, they essentially differ from other banks in the limited services that they offer to their customers.

The Courts in Dimension and U.S. Trust, while not bestowing their blessings on nonbank banks, recognized that the language of the BHCA allows these institutions to exist. Moreover, the Eleventh Circuit in U.S. Trust specifically conceded that, by its 1966 and 1970 amendments of the definition of "bank" in the BHCA, Congress "inadvertently created the opportunity for nonbank banks to spring to life." Indeed, the legitimacy of nonbank banks was a prerequisite to the existence of a justiciable case or controversy in Dimension and U.S. Trust.

With regard to Congressional action on the nonbank bank issue, I note that both the Dimension and U.S. Trust decisions stress that it is the role of Congress, not the agencies or the courts, to make any necessary amendments to the BHCA. However, with respect to the question of whether nonbank banks should be banned by the closing of the so-called "nonbank bank loophole", I reiterate that I would prefer to see all banks granted greater freedom to pursue diversification more directly. This freedom, coupled with the more liberal interstate state initiatives, should reduce incentives to charter or own nonbank banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
ROBERT L. CLARKE

Q.1. **By permitting out-of-state banks to buy up failing banks, how much have we contributed to the concentration of the banking industry?**

Should legislation allowing interstate purchases of failed or failing banks attempt to set limits on the overall size of our largest banks or bank holding companies or limit the number of banks that any one holding company can buy?

The emergency acquisition provisions of the Garn-St Germain Depository Institutions Act of 1982 were used only twice before they expired last year. In February 1986, the assets and liabilities of Park Bank of Florida were acquired by a newly created bank subsidiary of Chase Manhattan Corporation. In July 1986, a newly chartered bank subsidiary of First Interstate Corporation acquired the assets and liabilities of the First National Bank and Trust Company of Oklahoma City. These acquisitions had virtually no effect on concentration in the U.S. banking market. The failed banks had 2/1000ths of 1 percent and 6/100ths of 1 percent, respectively, of the system's assets when they failed.

Additionally, neither of these acquisitions had any effect on concentration in those local banking markets. The acquiring firms were not previously in those markets, so with their entry the number of competitors in each market was unchanged. Had the failed banks been liquidated or acquired by firms that were operating in those markets, the number of competitors would have declined and the level of concentration would have, of course, increased.

I oppose statutory limits on the overall size of banks and bank holding companies or on the number of banks that any one holding company can buy. Such limits could frustrate the purposes of legislation providing for interstate acquisition of failed and failing banks. If a large bank were failing, only a relatively large organization would be in a position to acquire it. Eliminating a significant number of the potential bidders would reduce the likelihood that the FDIC would get a favorable bid for such a bank. I am confident that enforcement of existing antitrust laws, and the absence of barriers to entry by new banks, will continue to ensure vigorous competition in banking.

Q.2. Many concerns have been expressed that the large banks that buy up many of the failed banks simply do not have the interest in the community or in delivering quality service to the small bank customer that locally owned banks do. What has been the consumer and community reaction to the newly formed banks or reorganized banks that have resulted from acquisitions of failed banks?

I have no evidence regarding consumer and community reaction to the newly formed banks or reorganized banks that have resulted from the acquisition of failed banks.

Such transactions do provide benefits to the community. When the FDIC arranges the merger or acquisition of a failed bank, depositors typically receive full protection of their deposits, even those that exceed the $100,000 insurance limit. Another important benefit of such solutions is that banking services to the community continue uninterrupted. Furthermore, a healthy institution generally is better equipped to meet community credit needs and to provide more innovative products and services than is a weak bank.

Because of the benefits that can be realized by both a community and the FDIC through the acquisition of a failed bank by a healthy institution, I strongly urge Congress to reinstate and expand the emergency acquisition provisions of the Garn-St Germain Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GRAHAM FROM
ROBERT L. CLARKE

Q. 1. **On page 9 of your testimony, you state that the Dimension and U.S. Trust cases recognize that nonbank banks are legitimate financial institutions but that they do not address the precise issues presented. If these two cases do not address the precise issues, why have you asked the lower court to vacate the preliminary injunction on the basis of the two cases which don't affect the IBAA case? Is your legal course of action consistent with your written statement? Or is your legal course intended to expedite action as soon as the injunction is vacated?**

The Dimension and U.S. Trust cases are relevant to the IBAA v. Conover case despite the fact that all of the issues in the these cases are not identical. Without going into elaborate detail on the facts of the cases, let me briefly explain that IBAA v. Conover deals with the interpretation of provisions of the National Bank Act, specifically the Comptroller's authority to charter limited service banks. Plaintiffs assert that the Comptroller is not empowered to grant charters to national banks that do not intend to both accept demand deposits and engage in the business of making commercial loans, activities which are both included in the definition of "bank" in the Bank Holding Company Act.

Furthermore, plaintiffs assert that the Florida District Court must look to historical usage and banking practice to determine the elements of the business of banking, rather than to define the business of banking on the basis of express statutory language. This assertion is in direct conflict with the courts' decisions in Dimension and

U.S. Trust. Among other things, those decisions stress that, in determining the purpose of a statute, the courts must first rely on the plain language of the statute itself. If the statutory language is clear, inquiry into the legislative purpose ends there.

In light of these decisions, we believe that the Florida District Court's issuance of the preliminary injunction is inappropriate. A preliminary injunction is issued when the court concludes that the parties requesting it are likely to succeed on the merits of their claim. This now appears unlikely because the Florida District Court's rationale for approving the injunction is in conflict with the Dimension and U.S. Trust decisions. Therefore, we have sought to have the injunction lifted.

The OCC's decision to file the motion to vacate was not intended to expedite the approval of nonbank banks as soon as the injunction is lifted. Rather, it represented the Department of Justice's and the OCC's tactical judgment regarding the best legal strategy to adopt in order to have the legal issues in this case resolved. If the court does not grant our motion, it is our intention to ask the court to proceed with the trial of the case on its merits.

Q.2. **On page 5 of your testimony, you state you recommend eliminating the minimum threshold for eligible institutions. What about concentration concerns? Would they apply?**

I strongly support eliminating the minimum threshold because over 96 percent of problem national banks have fewer than $500 million in assets.

I do not believe that elimination of the minimum threshold raises concentration concerns. Permitting an out-of-state institution to acquire a failed or failing bank would have no effect on the level of concentration in a particular market unless the out-of-state institution were already in that market. The number of competitors would be unchanged. On the other hand, if the failing bank were acquired by a firm that is already in the market, concentration in that market would increase.

The acquisition of small banks would have virtually no effect on concentration in the U.S. banking system. At year-end 1986, total assets in U.S. banks were in excess of $2.6 trillion. A $500 million bank represents less than 2/100ths of one percent of that total.

Q. 3. Also on page 5 you discuss additional expansion opportunities by supporting out-of-state bank holding companies that acquire a troubled institution to acquire additional banks in the same state in which the troubled bank is located on the basis as an in-state bank holding company. Would this override state law?

The federal emergency acquisition law would override state laws that limit the expansion and acquisition opportunities of out-of-state bank holding companies that acquire failed or failing banks. As I stated in my testimony, additional expansion opportunities are important to attracting qualified acquirors of failed and failing banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
ROBERT L. CLARKE

Q.1. Of the over 300 non-bank bank charter applications pending, what percentage are by bank holding companies who filed the applications to avoid the interstate restrictions of the Douglas Amendment?

A. 1. Ninety-two percent of the pending applications involve proposed interstate moves by bank holding companies that would have been prohibited by the Douglas Amendment at the time of filing had they been applications for full service commercial banks. As a result of subsequent changes in state laws, we estimate that approximately one third of these applicants could now expand into new states without pursuing their pending applications.

Q. 2. In your testimony you indicate that the courts could prevent action on pending nonbank bank applications for years. What effect will the state laws which prohibit nonbank banks in their states have on the approval process?

A. 2. We believe that these state laws may be held invalid under principles of constitutional law. State legislation could be held to violate the Commerce Clause if it has the purpose and effect of discriminating against interstate commerce.

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Garn -- Clarke

Q.3. In its testimony, the American Council of Life Insurers states, "the fact that the U.S. banking system is generally perceived as being one of the soundest if not the soundest in the world suggests that the statutory framework governing the system should be updated and preserved, not discarded." Please comment.

A. 3. Although the banking system is currently sound, I am concerned about the long-term downward trends in bank earnings which several recent studies have documented. Changes in financial markets have eroded the distinctions among financial institutions and introduced new risks and uncertainty into the financial system. In light of these changes, I believe that a total reevaluation of the statutory framework is urgently required. Outmoded statutory restrictions that deny banks the opportunity to evolve with market conditions and compete in today's environment undermine the safety and soundness of the financial system. It is important that Congress give financial reform a high priority and not allow special interests that are intent on protecting their own markets and profits to stymie such efforts.

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Garn — Clarke

Q.4. Over the past fifteen years there appears to have been a distinct change in the profitability of the basic wholesale banking business as noted in the report recently completed by the Federal Reserve Bank of New York. I would be interested in your comments on the future viability of the banks referred to in that report.

A. 4. As noted in the Federal Reserve Bank of New York's Recent Trends in Commercial Bank Profitability, U.S. banks have lost their position as the primary providers of prime short-term commercial credit. Corporate borrowing has shifted from U.S. banks to the commercial paper market and to foreign banks. For example, from 1973 to 1984, the share of short-term business credit provided by New York City banks, which are principal providers of credit to prime commercial borrowers, declined by almost 40 percent. During this period, the commercial paper market and foreign banks more than doubled their share of short-term business loans.

The loss of high quality corporate lending opportunities, and thus corporate customers, has serious implications for wholesale U.S. commercial banks. With the erosion of investment-grade corporate lending, the loan portfolios of wholesale banks have taken on higher risk. The concomitant deterioration in asset quality has resulted in higher loan loss provisions, placing pressure on bank earnings. The reduction in the quality of bank loan portfolios has had a negative effect, moreover, on market assessments of these banks. This is evidenced by the decline in the credit ratings of money center bank holding companies. In 1979, nine money center bank holding companies had AAA credit ratings. Currently only one has a AAA rating.

The combination of technological changes, expanded foreign bank presence in the U.S., and greater sophistication on the part of corporate financial managers has reduced the competitiveness of the traditional products offered by U.S. banks and has led them to rely increasingly on nontraditional sources of income. If banks are to remain competitive in providing financial services, they must evolve and innovate along with other financial intermediaries in the provision of a wide range of financial products.

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Garn — Clarke

Q.5. I believe that about 15 years ago, 7 out of the top 10 largest banks in the world were U.S. banks and today only one of the top 10 banks in the world is a U.S. bank. I'd like your views on why the growth of U.S. banks relative to the growth of other banks has slowed down so dramatically.

A. 5. There are several possible explanations for why the top U.S. banks have grown less rapidly than the major foreign banks. Virtually all of the foreign banks in the list of the 10 largest banks in the world conduct extensive and comprehensive nationwide operations in their home countries. Their share of their domestic banking markets is significant and thus they have been direct beneficiaries of the growth in those economies. By contrast, in the U.S., Federal and state geographic restrictions have limited the ability of the largest U.S. banks to expand domestically. Much of the recent growth in U.S. banking assets has occurred at large regional banks.

The recent decline in the value of the dollar vis-a-vis the Japanese yen and major European currencies has also resulted in an increase in the relative size of foreign banks, when their assets are viewed in terms of dollars.

Another explanation for the relatively slower asset growth of the large U.S. banks has been an increased emphasis on strengthening their capital ratios. For most of the post-World War II period, U.S. commercial bank asset growth was accompanied by declining capital-to-assets ratios. Beginning in the late 1970s, the three Federal bank supervisory agencies took coordinated steps to increase bank capital ratios, particularly at the larger U.S. banks. This in turn has forced the large banks to place greater emphasis on earnings and profitability versus asset growth and market share.

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Garn -- Clarke

Q.6. **As you know, several U.S. money center banks have been in the business of underwriting corporate securities in Europe for a number of years, and as far as I know, they have done so without any particular problems or threats to the safety and soundness of the parent institution. If this is true, what is wrong with letting them underwrite corporate securities in the U.S. market?**

A. 6. As you have stated, overseas securities underwriting by U.S. commercial banks does not appear to have threatened their safety and soundness, and I believe that they should be allowed to underwrite corporate securities here at home.

Our review of the literature suggests that the risk of securities underwriting is low and very manageable, and certainly lower than the risks associated with many types of commercial bank lending activities. It has been well demonstrated that due to the short holding periods and high liquidity, corporate underwriting is far less subject to losses than is commercial lending. Moreover, the losses that do occur are quickly identified and measured -- a benefit to the customers, the shareholders, and the regulators. For these reasons, many other countries have not found it necessary to prevent banks from combining investment and commercial banking businesses.

It is worth noting that in addition to their underwriting experience abroad, U.S. commercial banks have substantial experience in the underwriting of U.S. Government securities and certain municipal securities in the U.S. Banks have demonstrated competence in these activities, and I see no reason why they would not fare as well in the underwriting of municipal revenue bonds and corporate securities.

Q.7. **The United Kingdom and Canada have recently taken substantial steps toward protecting the viability of their securities and capital markets by undertaking a significant restructuring of their financial system. Japan is currently discussing taking similar steps. Shouldn't the U.S. be undertaking the same major restructuring so that in the long run its capital and securities markets don't get left behind?**

A.7. I agree with you wholeheartedly. While each country's situation is somewhat different in terms of their financial regulatory structure, both before and after reform, all have the desire to enhance competition in their financial markets and to place their domestic financial institutions in a better position to compete with foreign financial institutions. I share those goals and similarly favor a redesign of the framework governing the financial services industry in the U.S.

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Garn -- Clarke

Q.8. I would like to return for a moment to the European underwriting affiliates already owned by many of our largest money-center banks. Isn't it possible that if we don't make our regulatory system more flexible, many of these money-center banks will have no choice but to move an increasingly larger percentage of their activities abroad, thus costing the U.S. jobs, capital and tax revenues?

Q.9. Earlier, reference was made to the major restructuring of financial markets undertaken by the United Kingdom and Canada which they view as necessary to protect jobs and increase competition. Over the years there has been an influx of foreign banks to New York's economy. Isn't it likely that significant deregulation in the U.S. will mean more jobs in the U.S. financial services sector as foreign institutions increase their presence here and less loss of jobs for U.S. banks?

A. 8.-9. U.S. money center banks conduct a significant amount of their business abroad and recently have expanded their trading operations in London. This is due to several factors. First, some banks have found it desirable to expand overseas so that they can operate in certain product markets (e.g., foreign exchange) 24 hours a day; second, their profitability can be strengthened by diversifying their income sources through pursuing activities that are permitted abroad but prohibited in the U.S.; finally, they can better serve their domestic and multinational customers by providing direct access to the international capital markets.

For those reasons, is likely that U.S. money center banks will continue to conduct a fair amount of financial business abroad, even if changes are made in our regulatory system. However, allowing a greater range of activities for commercial banking organizations in the U.S. would undoubtedly increase U.S. banks' domestic banking operations, as well as attract new entrants to the commercial banking industry from abroad. Such a development would increase domestic competition and employment.

Q.10. **The Federal Reserve has on several occasions voiced its concern that affiliations between banks and non-banking firms, especially securities firms, might pose grave risks to the inter-bank payment system. Is there any way of insulating banks from their affiliates so that the payments system and bank capital will not be put at risk by the activities of affiliates?**

A. 10. Yes. A great deal of protection can be achieved by limiting bank loans to, asset swaps with, and equity investments in its affiliates. Additionally, limitations can be placed on overdrafts permitted through affiliated banking institutions. Many of these protections are already in place; however, they can be strengthened if necessary.

It is important to note, however, that most of the activities under consideration for banks are no riskier than many activities already engaged in by banks. Indeed, many of the activities can provide a means for banks to diversify their assets and income sources, thereby lowering their overall risk level.

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Garn -- Clarke

Q.11 **The banking industry, including small banks, is facing increased pressure from competitors which have greater flexibility to respond to a dynamic market with products like the securitization of car loans and the securitization of consumer credit receivables. Do you see any way in which we can keep our banking system healthy and competitive without substantially altering the current regulatory structure to permit full competition among the financial services providers?**

A. 11. Ensuring the long-term health of commercial banking is one of my main concerns. I find the long-term trends in the banking industry disturbing. For example, since 1980, the return on assets for the median bank has declined 18 percent, or about 21 basis points. The decline in return on assets for small banks (under $25 million in assets) has been even more dramatic. Since 1980, the profitability of the median small bank has declined by almost a third. Furthermore, return on equity, a critical measure of the ability to attract and retain capital in the banking system, has eroded steadily from a median level for all banks of 14.4 percent in 1980 to 11.9 percent in 1985. For small banks the decline has been even more precipitous, from 14.4 percent in 1980 to 9.7 percent in 1985.

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Garn -- Clarke

It is clear that commercial banks must have new profit-making opportunities if they are to continue providing traditional services. New profit opportunities can come only with a revised regulatory environment. As I stated in my testimony, properly structured, there are few financial activities that cannot be combined safely with those activities now conducted by commercial banks. New products and services may involve different risks, but they are not likely to be more threatening to safety and soundness than the risks encountered by an unduly restrictive regulatory system that prevents banks from remaining competitive and efficient financial service providers.

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Garn -- Clarke

Q.12. As you are well aware, many issues concerning "conflict of interest" have been raised over the years going all the way back to the Glass-Steagall Act. Is there any evidence that the domestic underwriting and dealing activities currently engaged in by banks have led to any concerns about the safety and soundness of those banks or the banking system?

A. 12. As I noted in my answer to question 6, I believe that the risks associated with securities underwriting are low and very manageable, and certainly lower than the risks associated with many types of commercial bank lending activities.

While it is theoretically possible that securities underwriting by banks could, through one means or another, impair bank capital, in practice those possibilities have not materialized. I am not aware of any evidence suggesting that the domestic underwriting and dealing activities currently engaged in by banks have led to any concerns about the safety and soundness of those banks or the banking system. Banks that take positions in securities typically limit or hedge their activities to protect themselves against significant losses.

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Garn -- Clarke

Q.13. **The capital-raising mechanism in this country is becoming increasingly centered in New York. Wouldn't it make sense to improve the capital-raising abilities in other areas of the country by permitting the banking system, under proper regulation, to compete in this market?**

A. 13. There is no doubt that competition in the capital markets would be improved if commercial banks were authorized to offer investment banking services. There are, as you know, over 14,000 commercial banks in the U.S., serving a variety of financial markets. With the exception of the very largest commercial banks, most commercial banks have traditionally served relatively narrowly defined geographic markets. These banks know and are known by local business firms and households in those markets. If those institutions were permitted to provide a broader range of products and services to those markets, local businesses would have greater access to capital markets and households would have greater investment choices.

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Garn -- Clarke

Q.14. **Does the high degree of concentration which currently exists within the investment banking industry and excessive profits earned by those firms, cause any concern that there needs to be a greater competition in those markets? Wouldn't banks and other financial services providers be natural entrants in that market? If U.S. banks are prohibited from entering, isn't it more likely that instead of losing market shares to U.S. banks, securities firms will instead lose shares to foreign securities firms and foreign financial intermediaries?**

A. 14. There is no doubt that the investment banking industry is relatively concentrated and that current statutory restrictions preclude many qualified new entrants, including banks, from competing in that market. Artificial barriers to entry deny the public the benefits of increased competition such as lower prices and greater convenience.

There is also no doubt that commercial bankers have the skills, experience, and access to the technology that would make them effective competitors. Bank underwriting of a variety of securities, including U.S. government and local government securities, domestically and abroad has been extensive.

I also agree that foreign firms will continue to find securities underwriting in the U.S. attractive.

The U.S. capital market is the broadest and deepest in the world, and as such attracts interest from firms worldwide. The purchase of an equity interest in Goldman, Sachs & Co. by Sumitomo Bank is but one example of that interest.

Q. 15. **Why do you continue to advocate additional emergency acquisition authority given that Texas, Oklahoma, and other states have acted to allow interstate purchases?**

A. 15. One of the major purposes of the emergency acquisition legislation is to minimize the cost to the FDIC of the management of failed and failing banks and, at the same time, to permit banking services to continue to be provided to the community. Although a number of states have passed interstate acquisition laws, a number of those laws contain barriers that make it more difficult or expensive for the FDIC to assist interstate acquisitions. For example, Oklahoma's statute requires a bidding process that places a high preference on in-state bidders. This process discourages out-of-state bidders and makes it less likely that the FDIC will be able to minimize its costs. In addition, because of restrictions in some of the interstate compacts, the number of potential out-of state acquirors may be limited. The emergency acquisition legislation proposed last year would balance the preference for in-state bidders with the desirability of minimizing the cost to the FDIC. Therefore, I continue to urge its passage.

Q. 16. You have said that you will give Congress a reasonable period of time to address the nonbank bank questions. Why did you file a motion to have the District Court in Florida lift its injunction in IBAA vs. Conover?

A. 16. The motion filed to have the District Court for the Middle District of Florida lift its preliminary injunction in IBAA v. Conover was a function of the recent decisions handed down by the Supreme Court in Board of Governors of the Federal Reserve System v. Dimension Financial Corp. (Dimension) and the U. S. Court of Appeals for the Eleventh Circuit in Florida Department of Banking and Finance v. Board of Governors of the Federal Reserve System (U.S. Trust).

The Florida court's issuance of the preliminary injunction was based in part on the court's conclusion that the parties requesting the injunction are likely to succeed on the merits of their claim. In light of the decisions in the Dimension and U.S. Trust cases, we believe that this is unlikely.

Moreover, the injunction has called into question the OCC's chartering authority, which is granted under provisions of the National Bank Act. Thus, the OCC's motion to lift the injunction also is motivated by our interest in clarifying our statutory authority and resolving the legal issues in the case on their merits.

I want to stress that the motion was not filed with the intention of denying Congress a reasonable period of time in which to address nonbank banks and related issues.

Q. 17. Does your approval of the D. C. charters violate your commitment regarding nonbank banks?

A. 17. No. None of the applicants which have received preliminary approval to establish banks chartered by the District of Columbia have indicated an intention to operate as limited service banks. Thus, my actions with regard to these banks is consistent with my commitment to allow Congress a reasonable period of time in which to address nonbank banks and related issues.

It also should be stressed that the applications which we have received are for the establishment of D. C. banks, not national banks. The OCC's approval of these applications is a function of the dual banking system that has existed in the District of Columbia since at least 1922, when Congress vested in the Comptroller authority over banks with a D. C. charter.

Our final approval of these applications is conditioned on the applicants' compliance with any regulations issued by the D.C. Superintendent of Banking and Financial Institutions that the OCC deems applicable. The D.C. Superintendent will be the primary supervisor of these banks although the OCC will, of course, remain the primary federal regulator. In the interest of safety and soundness their activities may be restricted by the D. C. Office of Banking and Financial Institutions and, if necessary, by this Office acting under federal authority.

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Garn -- Clarke

Q.18. During the hearing, a member of the committee (Senator Dodd) made the point that "[d]eregulation should not be an end but a means to an end". Would you react to that statement, please?

A. 18. I agree with Senator Dodd's comment. The OCC advocates financial reform not for its own sake, but because we believe it would strengthen our financial system and increase competition. Providing banks with the flexibility to engage in expanded financial activities that do not raise the overall risk in the banking system will ensure that they remain vital competitors in the market for financial services and that consumers receive the greatest variety and lowest cost in the financial services marketplace.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM ROBERT L. CLARKE

Q.1. **If a bank holding company is allowed to engage in securities underwriting and this is an appropriate banking activity, and you believe that commerce and banking should remain separate, do you also feel that no commercial concern should be able to acquire a firm that engages in underwriting activity? If commercial entities are allowed to acquire securities firms, which you have characterized as an appropriate banking activity, then why shouldn't commercial firms be allowed to engage in other banking activities? How do you draw the line?**

A. 1. First, I agree that it is very difficult to draw the line between commerce and banking. I am not opposed to nonfinancial firms acquiring investment banking firms. Such acquisitions could provide additional sources of capital and thus strengthen the investment banking firms. Second, I do not necessarily agree that commerce and banking need to remain separate. I believe that appropriate safeguards can be put in place to protect the bank against risks associated with a nonfinancial firm.

Many major U.S. corporations today compete directly with commercial banks in the provision of consumer and other types of credit. How does one distinguish between the financing activities of General Motors Acceptance Corporation and a commercial bank auto loan department or General Electric Credit Corporation and a commercial loan department?

Our ultimate objective should be to strengthen our financial system by removing obsolete rules that restrict the ability of banks and other providers of financial services to remain competitive in the global marketplace. Our pursuit of that objective should not be hampered by efforts to maintain an arbitrary distinction between banking and commerce.

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D'Amato -- Clarke

Q. 2. On page 12 of Undersecretary Gould's Testimony, he states that the Treasury would support expanded products and services for banks through separately capitalized facilities. What specific safeguards would you suggest to insure that the same self-dealing and conflicts of interest that were revealed in the hearings culminating in the Glass-Steagall Act? For example, should a bank's securities subsidiary be permitted to underwrite or securitize the credit extended by the parent bank?

A. 2. In offering any product or service to the public, banking organizations should be held to similar standards as other providers of those products or services. And, of course, all bank activities -- whether offering traditional lending services, other current products, or new expanded products -- should be conducted in accordance with high standards of fair business practices.

With regard to securities activities in particular, a regulatory scheme which addresses the problems of self-dealing and conflicts of interest present in the pre-1933 period now exists. The securities laws passed along with and subsequent to the Glass-Steagall Act have created a highly developed system of securities regulation and protection for purchasers of securities. These provisions address many of the problems of self-dealing a conflicts of interest, primarily by requiring stringent disclosure. As applied to banks offering expanded securities products and services, these requirements woul offer the same protection for investors.

Indeed, there is considerable debate among scholars regarding self-dealing and conflicts of interest abuses by banks in the pre-1933 period. It is not clear how common abusive practices were or whether they represented something intrinsic to banks or merely an example of securities abuses generally in the period. Similarly, many of the problems against which the Glass-Steagall Act was ostensibly directed in fact arose for reasons independent of banking practices and were cured by measures other than the Act.

Furthermore, there have also been marked developments in many bank regulatory and supervisory areas. At both the state and federal levels, there are extensive provisions governing bank fiduciary activities, bank relationships with affiliates or insiders, and many other areas. The federal banking regulators also have greatly expanded enforcement authority. These developments, which apply to bank securities activities as well as to all other banking activities, act to remedy the problems with which the 1933 Congress was concerned.

Hence, these strengthened provisions of banking regulation and supervision, as well as the development of an extensive regulatory framework for securities markets, make the environment for bank securities activities today unlike that of the pre-Glass-Steagall period. These developments provide the needed safeguards for relations between the bank and its separately capitalized company as well as for relations with customers, with respect to any potential problems of self-dealing and conflicts of interest like those discussed in the hearings prior to the Glass-Steagall Act.

With respect to the specific example you raise of a bank's securities subsidiary's activities on behalf of its parent bank or affiliated companies, we believe such activities are permissible. Application of the general principles of securities regulation and disclosure should suffice to protect investors. Similarly, the laws, regulations, and supervisory oversight concerning relations between a bank and its affiliates and its insiders will apply to protect the bank and the banking system.

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D'Amato -- Clarke

Q.3. Many critics of the Glass-Steagall Act suggest that banks have been squeezed out of their traditional sources of revenue and therefore need to expand into the areas of security underwriting. This argument seems hollow in light of the Wall Street Journal article demonstrating the profitability of these institutions through their traditional lines of business. Incidentally, the most profitable banks are those that are most vociferously arguing for the expansion of bank powers. Would you comment on the internal inconsistency of this argument?

A. 3. Large U.S. banks (those referred to in the Wall Street Journal article) have not maintained profitability through their traditional lines of business. In fact, U.S. banking industry profits have been weakened, in part, by the erosion in market share of portions of its core lending business. At many banks, this weakness is not fully reflected in current earnings figures due to nonrecurring sources of income such as securities gains. Other banks have sought to expand into relatively new activities, such as interest rate swaps, as a way to maintain profitability. Providing banks greater flexibility in adjusting to the declining profitability of commercial lending would help ensure a stronger and more stable commercial banking system.

Q. 4. On page 12 of your testimony you state that "an appropriate legal and operational structure to allow banks needed flexibility while still achieving our public policy goals. Properly regulated, I believe that there are few, if any, business activities that cannot be safely combined with banking." What specific framework do you mean when you refer to "appropriate legal and operational structure" and "properly regulated?" If "properly regulated" are there any commercial entities that should not be permitted from combining with banking?

A. 4. Under current law, there is a framework prescribed for the operations of banking organizations. Statutes and regulations provide for the types of businesses that may be conducted respectively in banks, bank subsidiaries, or bank affiliates. See, e.g., 12 U.S.C. § 24(7)(National Bank Act); 12 U.S.C. § 1843 (Bank Holding Company Act). Similarly, statutes, regulations, and supervisory provisions sometimes impose restrictions or limitations on the manner in which a business is conducted. See, e.g., 12 U.S.C. § 84; 12 C.F.R. Part 32 (national bank lending limits). Finally, some laws specifically address transactions between a bank and its affiliates or between a bank and bank insiders. See, e.g., 12 U.S.C. § 371c (affiliate transactions); 12 U.S.C. § 375b (insider loans).

This existing framework can be expanded to create a legal and operational structure that can flexibly accommodate a diversified institution. Some lines of business (both current and new) may be accommodated within the existing structure. For other lines of business, a certain measure of separation and insulation from the bank may be proper. For instance, certain activities could be conducted in separate subsidiaries or affiliates. Barriers could be constructed to prevent abusive transactions between the bank and those separate companies, such as limitations on bank investment in or credit to an affiliated "commercial" company, without flatly prohibiting all combinations of commerce and banking.

The OCC would be happy to work with the Committee and its staff to craft the specific rules that would accomplish appropriate amounts of protection.

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D'Amato -- Clarke

Q.5. Do you think there should be some restrictions placed upon a bank's ability to issue letters of credit? Are you concerned about the volume of debt supported by bank letters of credit?

A. 5. There are, at present, restrictions on banks letter of credit activities. For example, standby letters of credit are subject to the normal legal lending limits of national banks. I do not believe that it would be appropriate to impose additional limitations on a bank's ability to issue letters of credit.

When a bank issues a standby letter of credit, it assumes the same credit risk that it would have assumed if it had granted a direct loan of an equivalent amount to the same customer. Thus, in my view, when deciding whether to grant a letter of credit, bank management should apply the same credit standards and exercise the same care that it would use in making its decision to grant a loan. Similarly, pricing should reflect the risk assumed.

The OCC takes several steps to ensure that banks' letter of credit activities are conducted in a prudent manner. During the examination process, examiners give the same scrutiny to letters of credit and other off-balance-sheet instruments as they give to direct extensions of credit. Similarly, the risks to which those activities expose a bank are also considered by examiners in their assessment of a bank's overall condition and capital adequacy.

In support of my conviction that the risks assumed in these activities should be backed by capital, the OCC, in conjunction with the the FDIC, and the Board of Governors of the Federal Reserve System, is developing capital standards that explicitly account for off-balance-sheet risks. The Federal Reserve published a proposal for such a risk-based capital standard on February 12; the OCC anticipates publishing a similar proposal in the near future.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

L. WILLIAM SEIDMAN

Q.1. The House and Senate passed versions of the "Regulators' Bill" last year that differed from each other in a number of respects. Which would you prefer, the House or Senate provisions governing, for example: (1) the asset size test; (2) the sale of holding company subsidiaries; and (3) the terms of out-of-state holding company expansion in-state?

Please provide us, as soon as you are able, with a detailed statement of the provisions you would like to see enacted.

Answer: Enclosed is a draft bill developed by the FDIC incorporating all the provisions we would like included in a "Regulators' Bill." In addition, we have prepared the enclosed chart comparing the current House bill -- H. R. 26 (which is the same as the House bill from the last Congress), the Senate bill from the last Congress and the FDIC's position on each provision.

Two provisions that were included in the Senate bill of the last Congress, that were not contained in the House version, are particularly important to the FDIC. The first would have allowed the FDIC to form bridge banks for a temporary period of time in order to facilitate orderly and efficient acquisitions of failed banks. The other provision would have exempted the FDIC, as well as the other nonappropriated federal financial institution agencies, from the apportionment dictates of the Office of Management and Budget. We continue to strongly support both of these provisions.

Our preferences in the three specific examples noted in your question are indicated in the enclosed chart. With respect to the asset size test, we believe a zero threshold would best serve the banking industry and best promote the safety and soundness of the banking system. A zero threshold would permit the FDIC to resolve a greater number of failed and failing bank situations through purchase and assumption transactions. Such transactions are preferable since they make all depositors whole and, thereby, promote fairness in the way uninsured depositors are treated in small and large banks. In choosing between the House asset size test (*i.e.*, "$500 million or one of the ten largest banks in a state") and the Senate's $250 million threshold, we believe either version would be acceptable. The Senate version would allow emergency acquisitions for a greater number of failed and failing banks. However, the House version would be particularly valuable in the many states that have very few banks over $500 million.

With respect to the provisions in the House and Senate bills governing the sale of holding company subsidiaries, we do not have a preference for either version. We have no objection, however, to a provision that permits a single bank holding company system to be purchased by more than one out-of-state bank holding company since that merely increases the FDIC's options for handling failing banks.

The FDIC strongly believes that an out-of-state bank holding company that acquires a failing or failed bank should be able to expand to the same extent as an in-state bank holding company and a bank so acquired should be able to branch to the same extent as an in-state national bank without delay. Thus, we would prefer the House version from last year, but excluding the phrase, "unless otherwise provided under the laws of such state". We believe that the two-year waiting period that was provided in the Senate bill would significantly dampen investor interest in failed and failing banks.

Q.2. Your agency's "bridge bank" proposal would give the FDIC up to three years to handle a closed institution and in the meantime continue to provide banking services to its customers. A "conservatorship" power of this sort may, it seems to me, be a desirable and significant enhancement of FDIC authority.

If you had had this authority in 1986, how many people would have been able to receive uninterrupted banking services?

How much money would the FDIC have been able to save in failed bank handling costs?

Answer: We are unable to provide any reliable data on how many people would not have had their banking services interrupted had we "bridge bank" power in 1986. Last year we used an insured deposit payoff or insured deposit transfer with respect to 40 failed banks. These 40 banks averaged $31.2 million in deposits and averaged $0.6 million in uninsured deposits. In such cases uninsured depositors are exposed to loss, and even insured depositors are inconvenienced to the extent the terms of their deposit arrangements with the failed banks are terminated. In addition to depositors, there are many borrowers whose notes might have been purchased had there been an acquiring bank. This would have been much less disruptive than having the FDIC liquidate the loans.

Estimating the potential cost savings also is very difficult. We believe there were instances last year where the availability of a bridge bank option would have reduced the cost to the insurance fund. Given more time, purchase and assumption transactions might have been arranged rather than the more expensive payoff or transfer options. In addition, there were purchase and assumption transactions where, given more time, higher premiums or otherwise more favorable terms may been available to the FDIC.

Q.3. Your "bridge bank" proposal does not appear to do anything to bring to an end the "failsafe" status of large banks.

In my judgement, this status is not provided for in law and has been the basis for the difference in the way uninsured depositors are treated in small and large banks; has encouraged large depositors to shun small banks in favor of the large money center banks thus increasing banking concentration in this nation; and has enabled the money center banks to take on enormous amounts of off-balance sheet and other fee-related risks.

Does your "bridge bank" proposal address the problem of de facto 100% deposit insurance for our largest U.S. banks?

Answer: The bridge bank proposal may not bring an end to the "failsafe" status of depositors in large banks. However, if implemented, the proposal would make it more feasible to close large banks and gain time to develop a solution that will limit FDIC costs and disruption to the banking system. The bridge bank also would strengthen the FDIC's negotiating position (by providing a closed-bank option) in dealing with bank creditors where an open bank solution may be desirable. Thus, the bridge bank has the potential for disciplining bank shareholders and creditors, if not depositors. The FDIC continues to favor depositor preference which would place all nondeposit creditors of banks at considerable risk. Such creditors, including off-balance-sheet creditors, would not have their claims assumed in a purchase and assumption by the institution going forward as a bridge bank.

With respect to deposits, we recognize that the system has been moving in the direction of _de facto_ 100 percent insurance for both large and small banks. Some within the FDIC believe that it would be appropriate for Congress to enact 100 percent deposit insurance coverage and "target" nondeposit creditors for increased discipline. Another option would be to carve out some class of depositors from assessments and insurance coverage. We are studying these issues within the FDIC at the present time.

Q.4. In late December, the Comptroller of the Currency, gave preliminary approval for four large New York City based bank holding companies and two other firms to open so-called full-service banks in the District of Columbia pursuant to a now-closed loophole in the District's banking laws. Those approvals could permit those banks to engage in a whole list of securities activities not now permitted for Federally chartered banks, including the underwriting of corporate equity and debt.

I understand the Comptroller's final approval is contingent upon, among other things, the new institutions' obtaining FDIC insurance. Do you think the FDIC should grant those institutions Federal insurance and thus give its approval to what is in reality an effort to evade Federal banking law restrictions?

Answer: The law is very specific regarding the granting of Federal deposit insurance. In the case of a National bank or a state chartered bank which becomes a member of the Federal Reserve System, the Federal Deposit Insurance Act provides that it "shall be an insured bank from the time it is authorized to commence (business)." In the case of a State chartered institution which does not become a member of the Federal Reserve System, the Act requires that, before granting insurance protection, the FDIC Board of Directors must consider:

> "The financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of this Act."

The specific reference that you make to proposed banking operations in the District of Columbia is, at present, somewhat of a hybrid situation. While the institutions involved would be issued "District charters," it is the Office of the Comptroller of the Currency which exercises jurisdiction. The

Comptroller of the Currency conditioned his recent approval of such applications on the banking entity obtaining Federal deposit insurance coverage prior to commencement of business. This condition is very typically imposed by the various state chartering authorities. To date the applications have not been acted on by the FDIC.

We cannot offer a prejudgment on the final disposition of the applications, nor do we think it appropriate to engage in speculation as to the probability for approval or denial by the Board of Directors in any specific case. As with all requests for Federal deposit insurance coverage, the Board of Directors will consider the statutory factors as set forth in the Act after having conducted an appropriate investigation of each of the individual proposals.

We would point out, however, that many of the issues posed by the current applications for a District charter do not appear to be unique. There have been numerous cases of State chartered institutions being authorized and in fact actually engaging in financial service activities that are currently not authorized for certain Federally-chartered banks. To the extent that such institutions are operated in a safe and sound manner and do not represent an undue risk to the Federal deposit insurance fund or the stability of the banking system, the FDIC has seen no reason to object to such operations. In fact, we believe the exercise of these new powers by such institutions has both increased competition and met customer needs. In our experience, these banking organizations have generally been sound, well managed and have posed no more of a supervisory concern than traditional commercial banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GRAHAM FROM

L. WILLIAM SEIDMAN

Q.1. Did you use a form of a bridge bank in any previous situations in Oklahoma or Texas without this legislative action: If not, what was the difference in the situation:

Answer. We have not used any form of bridge bank in Texas, Oklahoma or elsewhere. In 1986 there were 42 bank failures in Texas and Oklahoma. Of these, 26 were handled through purchase and assumption transactions, eight were payoffs and eight were insured deposit transfers. These two states accounted for about 40 percent of the bank failures in 1986 which were not handled through a purchase and assumption. In at least three instances, we could not attempt a purchase and assumption because there was not sufficient time to adequately assess asset quality. If available, bridge bank powers might have been useful in all of these cases in that we would have had more time to try and find willing buyers.

Q.2. The argument has been made that the bank holding company structure is sufficient to insulate the bank from the risks associated with greater involvement in riskier nonbanking activities. Do you agree that the bank holding company structure is effective in this regard? Why?

Answer: The provisions of the Bank Holding Company Act, and especially the restrictions on transactions between banks and nonbanking affiliates contained in Section 23A of the Federal Reserve Act, appear to have been effective in insulating banks from the risks associated with the limited number of nonbanking activities currently permitted bank holding companies. However, as holding companies expand into new activities, it may become necessary to establish a new set of 23A-type restrictions. For example, at some point we may need to address loans to customers of affiliates.

We currently are in the process of studying the extent to which a bank can be insulated from less traditional and potentially riskier activities. At this point, however, we clearly have not reached the conclusion that banks cannot be effectively insulated. Nor do we share the view that the powers currently sought by the banking industry are riskier than traditional banking powers. In fact, we are inclined to believe the opposite.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

L. WILLIAM SEIDMAN

Q.1. In your testimony, you applaud actions taken in states such as Texas, who now permit interstate acquisition of failing institutions -- but you quickly point to a number of states who have had a large number of failures but have yet to change their laws. Can the increased expense to the FDIC in resolving a failed bank in a unit banking state be quantified? If so, should these banks in those states be required to pay a risk based premium for FDIC insurance?

Answer: It is difficult to quantify the increased cost resulting from the absence of a law permitting interstate acquisition of a failing bank. Several states with high numbers of bank failures in 1986 recently have passed interstate banking laws. There remain twelve states, seven of which had an aggregate of 46 failures in 1986, which do not permit emergency acquisition by out-of-state institutions. Of these 46 failures, 13 were either payoffs or insured deposit transfers, which are similar to payoffs in their impact on the FDIC. If interstate acquisition laws had resulted in some of these failures being handled by a purchase and assumption, the FDIC would have received premiums lowering the cash outlays required and also would have had a lower volume of failed bank assets which must be liquidated. Also it is reasonable to assume that, due to increased competition, the FDIC would have received higher premiums in some of the failures in these states which were handled through a purchase and assumption.

As to states that prohibit or limit intra-state branching, we are unable to provide estimates of the increased cost of handling failures in them. We would repeat our conviction that the absence of in-state merger possibilities has been a significant factor in preventing banks from resolving their own problems before failure and in limiting the FDIC's options after failure.

Charging higher premiums to banks in states without emergency interstate acquisition laws or with limited branching powers is a conceptually appealing idea. However, much further study would be necessary. The need to judge the adequacy of each state's law, the difficulties of pricing the increased risk, the question of states rights and other potential problems suggest that this matter is more readily dealt with by legislation along the line suggested in our testimony.

Q.2. In his testimony, Ed Gray estimated that the cost of delaying FSLIC recapitalization was as much as $5 million per day. Can you provide any estimate to delaying enactment of increased emergency authority, including bridge bank, for the FDIC.

Answer: Our cost relates to how much might be saved by having more tools to handle future bank failures at a lower cost. There is no realistic way to estimate such savings. Mr. Gray's estimate, I believe, related to an existing number of institutions which are basically insolvent but are permitted to remain open and which continue to lose money at the rate indicated. Such

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losses ultimately will be absorbed by the FSLIC if the institution is closed. We have dealt with and will continue to deal with failed banks as they are judged insolvent by the chartering authority. We have no "inventory" of existing insolvencies.

Q.3. Over the past fifteen years there appears to have been a distinct change in the profitability of the basic wholesale banking business as noted in the report recently completed by the Federal Reserve Bank of New York. I would be interested in your comments on the future viability of the banks referred to in that report.

Answer: As you noted, the profitability of large, wholesale banks has declined somewhat in recent years. After controlling for cyclical economic conditions over the period 1970-84, the Federal Reserve Bank of New York study concluded that money center banks have experienced some modest deterioration in their return on equity in recent years. More recent data, however, indicate that there has been a modest upturn in large-bank profitability during 1985 and, excluding Bank of America's large losses, this trend continued in 1986.

Despite this recent improvement, there seems little doubt that the competitive position of money center banks in wholesale lending markets has eroded in recent years. The Fed study you referred to noted that the share of all short-term nonfinancial business credit at large weekly reporting member banks declined from 43 percent in 1974 to about 27 percent during 1985. Much of this deterioration has resulted from the increasingly popular process of "securitization".

While bankers tell us that the decline in the wholesale lending market has affected their profitability, it is difficult to assess its impact thus far. Whether high loan losses at these institutions have resulted from banks being forced to lend to less creditworthy customers, or are the result of the current economic environment is unclear. Probably a more important question, however, is the extent to which this process known as "securitization" could extend further to include not only wholesale lending, but other forms of bank lending as well. As the New York Federal Reserve Bank study noted, widespread "securitization" could result in a broad-based erosion in the profitability of intermediating credit through banks. Clearly this question merits our continued attention, and underlies the need to reassess the rules governing our financial system.

Q.4. I believe that about 15 years ago, 7 out of the top 10 largest banks in the world were U.S. banks and today only one of the top 10 banks in the world is a U.S. bank. I'd like your views on why the growth of U.S. banks relative to the growth of other banks has slowed down so dramatically.

Answer: The existing system of artifical barriers to competition has been a major factor contributing to the relatively slow growth of U.S. banks in recent years. Among these artificial barriers are the Glass-Steagall separation of investment from commercial banking and the many state-imposed restrictions on interstate banking. The enactment of Glass-Steagall over 50 years ago has served to isolate the U.S. banking system from the profitable business of investment banking - an area of banking that has become increasingly important in recent years. Without access to investment banking activities, banks have lost customers and profits as businesses increasingly turned to capital markets for financing. In addition, the geographic markets available to banks have been limited by state-imposed restrictions on interstate banking. A related factor is the notable lack of similar restrictions facing banks in other nations. While the growth of banks has been hampered by these restrictions, other banks have flourished in their absence. Clearly the relative imbalance in restrictions and regulations placed on banks has contributed to the decline in U.S. banks' international ranking.

Q.5. As you know, several U.S. money center banks have been in the business of underwriting corporate securities in Europe for a number of years, and as far as I know, they have done so without any particular problems or threats to the safety and soundness of the parent institution. If this is true, what is wrong with letting them underwrite corporate securities in the U.S. market?

Answer: Our experience shows that the underwriting activities of the major U.S. money center banks' overseas securities affiliates have not given rise to any particular problems or threats to the safety and soundness of their parent institutions. Because these affiliates have successfully participated in European corporate securities markets, we feel that U.S. banks should similarly be allowed to participate in the U.S. corporate securities market.

Q.6. The United Kingdom and Canada have recently taken substantial steps toward protecting the viability of their securities and capital markets by undertaking a significant restructuring of their financial system. Japan is currently discussing taking similar steps. Shouldn't the U.S. be undertaking the same major restructuring so that in the long run its capital and securities markets don't get left behind?

Answer: The recent restructuring of several overseas financial markets has brought a heightened degree of competition to international financial markets. In order to remain a viable competitor in today's international financial system, it will be necessary for the U.S. to undertake similar restructuring. Reducing or eliminating existing barriers to competition in U.S. capital and securities markets would allow increased market efficiencies to be realized. The benefits of increased competition and greater efficiencies would be felt both domestically - for example in the form of lower fees to purchasers of financial services - and internationally, where without reform the U.S. may be excluded from participating at all.

Q.7. I would like to return for a moment to the European underwriting affiliates already owned by many of our largest money-center banks. Isn't it possible that if we don't make our regulatory system more flexible, many of

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these money-center banks will have no choice but to move an increasingly larger percentage of their activities abroad, thus costing the U.S. jobs, capital and tax revenues?

Answer: Yes, without greater flexibility in our domestic financial system, it is reasonable to expect banks to continue to rely on their international activities for a growing share of their total business. As these banks continue to substitute international banking activities for domestic business, the cost of the U.S. will be in the form of lost jobs, lost tax revenues and the movement of capital abroad.

Q.8. Earlier, reference was made to the major restructuring of financial markets undertaken by the United Kingdom and Canada which they view as necessary to protect jobs and increase competition. Over the years there has been an influx of foreign banks to New York, the major domestic financial market, which has improved New York's economy. Isn't it likely that significant deregulation in the U.S. will mean more jobs in the U.S financial services sector as foreign institutions increase their presence here and less loss of jobs for U.S. banks?

Answer: Without significant deregulation the migration of business from U. S. domestic financial markets can be expected to continue. As indicated in our answer to question six, such deregulation is necessary and advisable. One benefit that would likely result from the return of U.S. international competitiveness would be an improved domestic economy. This would likely include the return of business from both domestic and foreign sources, and a reversal of the trends cited in our answer to question seven.

Q.9. The Federal Reserve has on several occasions voiced its concern that affiliations between banks and non-banking firms, especially securities firms, might pose grave risks to the inter-bank payment system. Is there any way of insulating banks from their affiliates so that the payments system and bank capital will not be put at risk by the activities of affiliates?

Answer: All business, investment and commercial activity entails some elements of risk including the traditional business of commercial banking. Affiliations between banking and "nonbanking" firms would not, in and of itself, necessarily increase risk -- it would merely change the nature of that risk. To some extent, such affiliations may actually reduce both systemic and individual bank risks by providing greater diversification, overall cost savings, additional management talent and, if needed, by serving as a source of capital infusion. On balance, we believe that nonbank affiliates are just as likely as bank affiliates to be a source of strength.

Can such affiliations ever pose grave risks to the payments system? It is not inconceivable, and we do not wish to minimize the dangers by suggesting otherwise. However, it does seem highly unlikely that systemic stability would be threatened by such affiliations if reasonable prudent practices are followed and there is appropriate supervision of the bank and all intercompany transactions. We believe that abuses can be controlled and held within manageable levels. Section 23A of the Federal Reserve Act which governs transactions between a bank and its affiliates is an example of controls which regulate but do not prohibit potentially beneficial relationships.

The separation of commercial banking from investment banking activities more than one half century ago was aimed, in large part, at eliminating potential conflicts of interest and protecting against potential abuses. The concerns are still valid, however the financial service environment has changed dramatically. Today, we have greater public disclosure of the activities of all publicly-owned firms in an era of deregulation and intensified market scrutiny. We also have a variety of bank supervisory mechanisms which have been developed over time to assess and control risk to banks and the banking system. Quite simply, we believe that risks can be safely managed and that there would not be any grave new threat to systemic stability posed by increased affiliations.

Further, in many instances, we believe that full insulation of the bank is neither necessary or desirable. A number of new (nontraditional) financial service activities, including many falling under the general category of "securities activities," can be safely conducted within the bank itself, directly adding to the bank's diversification of risk, profitability and range of customer services. Other activities can appropriately be conducted by subsidiaries and affiliates. Once again, statutory restrictions or mandated separations are not necessary if reasonable bank supervisory practices are followed.

Q.10. The banking industry, including the small banks, is facing increased pressure from competitors which have greater flexibility to respond to a dynamic market with products like the securitization of car loans and the securitization of consumer credit receivables. Do you see any way in which we can keep our banking system healthy and competitive without substantially altering the current regulatory structure to permit full competition among the financial services providers?

Answer: Today, inroads into the traditional areas of banking are being made by competitors who have access to the added flexibility of nontraditional financial products, such as the securitization of auto loans and consumer receivables. Without the ability to access these and other products that are reflections of the rapid changes occurring in financial markets, the banking industry, and particularly its small banks, are at a distinct disadvantage. To remain competitive, we feel that the regulatory structure must be amended to reflect full competition among the participants of the financial services industry.

Q.11. As you are well aware, many issues concerning "conflicts of interest" have been raised over the years going all the way back to the Glass-Steagall Act. Is there any evidence that the domestic underwriting and dealing activities currently engaged in by banks has led to any concerns about safety and soundness of those banks or the banking system?

Answer: Although the Glass-Steagall Act disallowed banks from underwriting and dealing in corporate securities, they have always been allowed to domestically underwrite and deal in government securities. Additionally, banks have used security affiliates to underwrite and deal in corporate securities in international financial markets. As mentioned in our answer to question five, these activities have not posed a problem or a threat to the safety and soundness of either the parent institution or the banking system as a whole.

Q.12. The capital raising mechanism in this country is becoming increasingly centered in New York. Wouldn't it make sense to improve the capital-raising abillities in other areas of the country by permitting the banking system, under proper regulation, to compete in this market?

Answer: Under the structure of today's financial markets, the ability to raise capital has become increasingly centered in the New York investment banking community. If we desire to improve the capital-raising abilities of other areas of the country, one solid approach would be to allow the banking system to participate in our capital markets. As we have mentioned in our answers to questions five and eleven, it is our belief that, under proper regulation and supervision, the banking system can safely participate in the activities associated with raising capital, and that it would be beneficial from the standpoint of our economy for the banking system to do so.

Q.13. Does the high degree of concentration which currently exists within the investment banking industry and excessive profits earned by those firms, cause any concern that there needs to be greater competition in those markets? Wouldn't banks and other financial services providers be natural entrants in that market? If U.S. banks are prohibited from entering, isn't it more likely that instead of losing market shares to U.S. banks, securities firms will instead lose shares to foreign securities firms and foreign financial intermediaries?

Answer: We are interested in promoting a sound and competitive financial system in which all firms are treated fairly and equitably. To the extent that investment banking remains highly concentrated, these goals cannot be met. We would prefer to see entry into the investment banking industry open to U.S. banks as well other providers of financial services. The exclusion of U.S. banks from the domestic investment banking market deprives this market of their considerable experience and expertise. It seems counterproductive to exclude domestic firms from a domestic market while foreign firms are not.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
EDWIN J. GRAY

QUESTION NO. 1 -- In your testimony, you indicate that part of the reason for the increasing number of failed thrifts is that certain state regulators have allowed state-chartered thrifts to engage in a wide variety of activities, resulting in failures due to bad management and risky investment. If you view such problems as significant, why should we ask the healthy thrifts to bail out the failing institutions before we have addressed the problems that have caused at least some of the thrifts to fail in the first place?

ANSWER TO QUESTION NO. 1.

FSLIC does not intend to "bail out" failing institutions at the expense of healthy thrifts. A "bail out" means using funds to support the continued operation of failing thrifts in a manner that benefits their shareholders and management. The funds made available through the bill will be used to ensure the full protection of insured depositors -- not management or stockholders -- as mandated by Title IV of the National Housing Act. The purpose of the bill is to provide the FSLIC with the financial resources necessary to resolve its caseload of insolvent or soon to be insolvent thrifts. Such case resolution will involve placing these terminally ill institutions in liquidating receiverships or providing FSLIC assistance to facilitate supervisory acquisitions or mergers.

Second, further delay would raise the costs to healthy thrifts. Net operating losses in FSLIC's significant supervisory caseload are running more than $6 million per day, approximately $2.2 billion annually. The rate of loss is increasing. These terminally ill and already failed thrifts are also the "high rate junkies" that help bid up the thrift industry's cost of funds by $4 billion annually as compared to FDIC insured banks. These massive costs of delay will have to be paid by healthy thrifts unless there is a taxpayer "bailout."

Third, the Bank Board already has taken a number of regulatory actions that should provide for a stronger, more resilient industry in the future, as discussed below. In addition, the Congress, by enacting the Garn-St Germain Depository Institutions Act of 1982, provided the industry with the tools to cope with the problems caused by the maturity mismatch problems of the late 1970s and early 1980s.

In my view, three regulatory initiatives of the Bank Board are particularly significant in addressing the two major problems that have contributed to the insolvency of a number of FSLIC-insured institutions. These initiatives are the imposition of higher capital requirements on FSLIC-insured institutions, requirement for supervisory approval of direct investments in excess of certain levels, and the dramatic expansion in our examination and supervision staff.

As discussed further in my response to the first question of Senator Garn (below), a major problem of thrift institutions in the first half of this decade has been severe undercapitalization. The low capital levels allowed excessive deposit growth, encouraged risky investment behavior, and failed to provide thrifts with a sufficient cushion to maintain solvency at times that they suffered losses. Accordingly, over the last three years, the Bank Board has adopted much stronger capital requirements. Specifically, in January 1985 and August 1986, the Bank Board increased required capital levels and incorporated a "risk-based" incremental capital requirement. In the rule adopted in August, 1986, which took effect January 1, 1987, the Bank Board required institutions to increase their capital, over a transition period, from an amount equivalent to three percent of liabilities to six percent of liabilities. The rule also requires institutions to post added capital for direct investments, land loans, and nonresidential construction loans. The amount of capital required for these investments varies depending on the institution's capital position and concentration of investment in such assets.

These changes recognize that institutions with low capital have an incentive to gamble for high returns from high-risk investments. Imposing higher overall capital standards, as well as additional capital requirements for certain risky investments will motivate each institution to make prudent operating decisions by giving the thrift a significant stake in adverse as well as positive outcomes of its decisions. In addition, institutions required to maintain higher capital levels will be better equipped to maintain solvency when they experience losses of any kind. This preserves the viability of the thrift industry and serves to better protect the FSLIC. The requirement that institutions "earn their growth," by posting additional capital as they grow, has largely ended excessive growth.

In addition, in 1985, the Bank Board adopted a regulation that places limitations on the extent to which state-chartered institutions can invest in direct investments; federally chartered institutions lack authority to make direct investments except for limited investments in service corporations that may engage in a narrow range of activities. This regulation in part is intended to control the level of risk that the Bank Board believes is associated with direct investments. With respect to an institution that satisfies regulatory capital requirements, the regulation requires the institution to obtain approval from its Principal Supervisory Agent before its level of direct investments can exceed a threshold level. An institution that fails to satisfy regulatory capital requirements may not make any direct investments without prior regulatory approval. On February 27, 1987, the Bank Board acted to strengthen the rule substantially and extend it for two more years. At the same time the Board sought comment on a proposed rule that would, in effect, treat high risk land loans as direct investments.

The third principal area of improvement has been in the number and quality of our examination and supervision force. As distinct from the freer regulatory hand accorded to the banking regulators, OMB and OPM restrictions crippled the Bank Board's ability to hire and retain an adequate force. We, therefore, delegated the examination function to the 12 Federal Home Loan Banks and more than doubled our field examination staff in little more than a year and a half. Our professional supervisory staffs in the Federal Home Loan Bank districts more than tripled in two and a half years. Oversight of the critical functions has been significantly strengthened with the establishment of the new Office of Regulatory Policy, Oversight and Supervision in Washington; a Federal Home Loan Bank System entity that reports directly to the Bank Board.

In sum, we have taken the measures essential to reduce greatly future failures. We had to overcome substantial resistance from the industry, OPM and OMB to make these reforms. We have no intention of "bailing out" managements and shareholders who drove their shops into insolvency. Every day of delay will cost the healthy thrifts at least $6 million.

QUESTION NO. 2 -- What evidence do you have that bad management and risky investment caused thrift failures? What percentage of thrift failures would you estimate were caused by bad management? What do you view as the other main causes of thrift failures in the last five years and what data do you have to support your conclusions?

ANSWER TO QUESTION NO. 2.

Management weakness, misconduct, and risky investment have contributed to the vast majority of thrift failures since 1984. My view is based on a review of various materials that have been submitted to the Bank Board during my tenure. These materials relate to our receivership actions and support the agency's enforcement activity.

Clearly, not all thrift failures during the last five years have been the result of managerial problems, and there were few cases where managerial problems were the sole cause of thrift insolvencies. A general explanation for the vast majority of thrift insolvencies is set forth in the answer to Senator Garn's first question (below). However, the following is a partial list of the various causal agents that, in addition to managerial problems, contributed to thrift failures: (1) asset-liability maturity mismatch; (2) inadequate capital; (3) inadequate diversification of investment risk; (4) imprudent underwriting of loans; (5) excessive growth; (6) speculative investment strategies; and (7) regional economic problems. Since greater management expertise is needed when the investments are riskier, managerial problems play a greater role in thrift failure, generally commensurate with the risk of investment.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM EDWIN J. GRAY

QUESTION NO. 1 -- Is it your position that the overwhelming majority of the problems have been caused by bad management and risky investment strategies rather than depressed regional economies or interest rate deregulation? If so, what evidence do you have to support this conclusion?

ANSWER TO QUESTION NO. 1.

The overwhelming majority of the thrift failures that will cause the FSLIC vast losses are the result of managerial weaknesses and risky investment strategies rather than depressed regional economics on interest rate deregulation. The negative spread problems weakened the net worth of many thrifts and made non-traditional investments more attractive to them. Similarly, depressed regional economics have hurt a large number of thrifts and exacerbated the losses at thrifts that have failed due to managerial weaknesses.

The primary role of managerial weaknesses and high risk investment in recent thrift failures is demonstrated by extremely persuasive evidence. First, our supervisory experience in reviewing demonstrates this fact. Second, a very large percentage of recent failures have been in California, which had a vibrant regional economy. Third, even in Texas, the evidence shows that our recent failures had the seeds of their destruction sown in 1982-1985, long before the sharp fall in the price of oil. My March 9, 1987 letter to you details these facts at pages 8-9. Please see my answer to Question number 4 with regard to our studies on losses from direct investments and high risk land loans.

QUESTION NO. 2 -- What is your view of the U.S. League of Savings Institutions' FSLIC recapitalization proposal? Do you see any way that a compromise between the FSLIC plan the U.S. League plan could be achieved?

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ANSWER TO QUESTION NO. 2.

The capital contribution component of the League Proposal is seriously flawed, and there is no basis for any compromise between it and the Bank Board/Treasury proposal. Specifically, the League Proposal is flawed because: (1) it fails to provide to the FSLIC sufficient funds to permit it to resolve its caseload within a reasonable period of time; (2) the inadequacy of capitalization will force the FSLIC to defer resolution of many cases thereby increasing the overall cost of resolution; (3) it will impair the credit standing of the Federal Home Loan Banks ("FHLBanks"); (4) it fails to provide investors with reasonable assurances that the Financing Corporation will have sufficient funds to redeem the bonds at maturity; (5) there is no evidence that there is a market for the bonds to be issued under the League Proposal; (6) the assumptions underlying the proposal are unrealistic; and (7) when those assumptions are adjusted to reflect realistic expectations, the League Proposal is a much less efficient financing mechanism than the one set forth in the Administration Proposal.

The U.S. League claims that its proposal plus FSLIC's insurance premiums,will provide to the FSLIC the following amounts (exclusive of funds derived from the return on the FSLIC's investment portfolio and the disposition of assets held by the FSLIC as receiver): $8.9 billion over two years, $13.8 billion over five years, and $20 billion over ten years. The Bank Board's staff, however, estimates that in reality the League Proposal would contribute to the FSLIC the following amounts: $7.5 billion over two years, $8.8 billion over five years, and $10.4 billion over ten years, as explained in the answer to Question 10 (below). In contrast, the Bank Board/Treasury Proposal is expected to provide to the FSLIC the following amounts (exclusive of funds derived from the return on the FSLIC's investment portfolio and the disposition of assets held by the FSLIC as receiver): $8.5 billion over two years, $19.7 billion over five years, and $19.9 billion over ten years, assuming the bonds bear interest at 8 percent. This is explained in the answer to Question 10 (below).

The staff of the Bank Board has estimated that, in addition to income from the FSLIC's investment portfolio and from the disposition of receivership assets, the FSLIC will need approximately $20 billion over the next five to seven years to resolve the FSLIC caseload in a cost-effective manner. The League Proposal provides only $8.5 billion to the FSLIC over that period. Accordingly, the League Proposal fails to satisfy the primary objective of recapitalization, i.e., to provide the FSLIC with sufficient funds to resolve its caseload in a timely and cost-effective manner.

This $11.5 billion shortfall will force the FSLIC to defer resolution of many of its cases. The staff of the Bank Board has estimated that by deferring resolution of these cases, the FSLIC will incur additional resolution costs of more than $3 billion. This additional cost reflects the fact that the insolvent institutions that will remain open are expected to incur additional operating losses on a daily basis. At present, the FSLIC's significant supervisory cases in the aggregate are losing approximately $6.6 million daily.

The League Plan would impair the credit standing of the FHLBanks. This impairment would result because that plan obligates the FHLBanks to dedicate twenty percent of their net earnings to the payment of the bonds for the life of the bonds. The impaired credit standing will force the FHLBanks to pay higher interest on their consolidated bonds, and they will be forced to pass on this higher cost to their member institutions.

The League Proposal also fails to provide a mechanism that will assure investors that the Financing Corporation will have sufficient funds to redeem the zero coupon bonds at maturity. The Bank Board/Treasury Proposal provides for defeasance of principal (with collateral that will increase in value over time) and periodic payments of accrued interest on the bonds to be issued by the Financing Corporation. The League Proposal requires investors to wait twenty years (or more realistically 30 years) before they get a penny back on their investment. The proposal also does not include a mechanism to assure that sufficient funds will be contributed to the sinking fund to provide for full payment of principal and interest. Accordingly, the staff of the Bank Board estimates that the interest rate on the League Proposal bonds will be 1-1/2 to 2-1/2 percent higher than the rate that would be paid on the bonds under the Bank Board/Treasury Proposal, as explained in my answer to your sixth question (below).

The assumptions underlying the League Proposal also are unrealistic. For instance, the League Proposal assumes that the bonds issued thereunder would pay interest at eight percent. However, in a market where the bonds under the Bank Board/Treasury Proposal would pay 8 percent interest, the marketplace would demand interest of 9-1/2 to 10-1/2 percent on the League Proposal bonds. In addition, the scenario in the League Proposal that provides for annual growth of 9-1/2 percent in the net earnings of the FHLBanks is unrealistic. The Bank Board's Office of Policy and Economic Research has determined that the net earnings will not grow to any significant extent, because of the affect of the annual contribution by the FHLBanks of twenty percent of their net earnings to the Financing Corporation. Investment bankers have briefed the House Banking Committee on the these issues, and one expert has testified publicly. They have been unanimous in their view that the League Plan has seriously flawed assumptions, that it is intrinsically less efficient, and that it is so deficient in its amount that their bonds might not be marketable.

More significantly, the League Proposal assumes that there will be a market for the proposed 20-year zero coupon bonds that will not be guaranteed by the full faith and credit of the United States. The staff of the Bank Board is of the view that there is not a market for 20-year zero coupon bonds. There is a market for 30-year zero coupon bonds. However, if the League Proposal bonds were to have a 30-year maturity, the amount due on the bonds at maturity would be a staggering $93.4 billion, assuming the bonds bore interest at ten percent.

The League Proposal is a less efficient financing mechanism than the Bank Board/Treasury Proposal. When the assumptions for that proposal are adjusted to reflect marketplace realities, i.e., a 30-year maturity and 10% interest, one finds that the debt service would be approximately $1.15 billion annually (including the contribution of $0.275 billion each year by the FHLBanks), where the FSLIC is provided only $5 billion of additional capital from the debt offering. The Bank Board/Treasury Plan provides the FSLIC with an infusion of $15 billion from the bond offerings with an annual debt service of $1.20 billion. A more detailed comparison of the two plans is set forth in my answer to Question 10 (below).

Because the League Plan's funding mechanism is inherently flawed, and the money it would provide grossly inadequate,I oppose any compromise between the Bank Board/Treasury Proposal and the League Proposal.

QUESTION NO. 3 -- You say in your testimony that merger of the insurance funds could not possibly mean commingling of these resources. If this is true, what possible reason could there be for justifying the merger?

ANSWER TO QUESTION NO. 3.

When I stated my opinion that merger of the insurance funds would not result in the commingling of the reserves of those funds, I expressed my observation that such a commingling appears to be politically infeasible. I expect that the banks would lobby strongly against such a plan, because they have no desire to pay for the cost of resolving the problems of the thrift industry. Moreover, it appears that the FDIC lacks sufficient resources to resolve the problems of the thrift industry in addition to the problems of the banks that are strapped with nonperforming energy loans and international loans. Accordingly, I continue to believe that any merger of the FSLIC with the FDIC would not result in the commingling of the reserves of those deposit insurers, but rather would result only in the transfer of the administrative functions of the FSLIC to the FDIC.

I do not believe that there is a valid reason for an administrative functions merger. Such a merger of the FSLIC into the FDIC would have adverse effects. Currently, the Bank Board has "cradle to grave" authority with respect to federally chartered thrift institutions. Such authority provides for a coherent system of regulation, oversight, supervision and enforcement. In addition, the FSLIC can expeditiously appoint a receiver or conservator for an insolvent federally chartered thrift, or arrange quickly for a supervisory acquisition, because it need not consult with another regulator prior to taking such action. These advantages would be lost if the FSLIC were merged into the FDIC.

In addition, I believe that merger of the FSLIC into the FDIC would be the first step in de-emphasizing the home-financing role of the thrift industry. In my view, such a change of emphasis is not desirable. However, if Congress were to effect such a policy shift, I believe it should do so only after a thorough study of the implications of such action.

Given the foregoing, I am of the opinion that a merger of the FSLIC into the FDIC is an unsatisfactory solution to the capital requirements of the FSLIC.

QUESTION NO. 4 -- Your testimony quotes statistics about the increased loss caused by direct investments in thrifts that have failed. Do you know of any statistics that show what percentage of thrift failures have actually been caused by direct investments? Conversely, do you know of any statistics showing what percentage of the profits of the thrift industry have been achieved through direct investments?

ANSWER TO QUESTION NO. 4.

I appreciate this opportunity to clarify my views on the relationship between direct investments and thrift problems. The statistics quoted in my testimony were derived from a report entitled "Failure Costs of Government-Regulated Financial Firms: The Case of Thrift Institutions" by J.R. Barth, R.D. Brumbaugh, and D. Sauerhaft (the "Barth Report"). Follow-up studies have confirmed that direct investments and high risk land loans are associated with substantial increases in FSLIC's cost of resolving thrift failures.

Studies conducted by the Bank Board's Office of Policy and Economic Research ("OPER") (discussed at Appendix A) demonstrate that direct investments by thrifts have frequently exacerbated the problems of some thrifts and that direct investments have been a significant contributing factor to many insolvencies. These studies found that reported book incomes from direct investments at failing thrifts were unreliable, and hid huge losses from such investments.

The OPER also has conducted a study demonstrating that on average direct investments have been less profitable for the thrift industry than traditional thrift investments. See Richard Brown, Joseph McKenzie, "Deregulation and Portfolio Returns: The Case of Thrifts", OPER Working Paper #126 (Feb. 12, 1987). The results of this study indicate that the average of the yields on nonresidential mortgage loans, land loans, service corporation investment and real estate investments that have been realized by the thrift industry is significantly less than the average of the industry's realized yields on one-to-four-family mortgage loans.

QUESTION NO 5 -- In your testimony you state that the existence of the non-bank bank loophole deters firms from acquiring ailing thrifts and injecting new capital in the industry. Yet you also propose authority for substantial exit-fee penalties. Is it the policy of the FHLBB to sell a failed savings and loan to commercial companies? Won't this proposed authority, even if it keeps some thrifts from leaving the industry, deter outside firms from acquiring thrifts?

ANSWER TO QUESTION NO. 5.

The policies of the Bank Board allow the sale of failed thrifts to commercial companies with appropriate safeguards against abuse. The clarification of our exit fee authority we have requested should have no effect on the willingness of commercial companies to acquire troubled thrifts. Exit fees are important as a matter of fairness, and to ensure the greatest degree of confidence to bond purchasers.

QUESTION NO. 6 -- Isn't the U.S. League recapitalization plan, because it offers no collateralized return of principal to investors and no periodic interest payments, likely to make the bond borrowing more expensive than the Treasury recap plan?

ANSWER TO QUESTION NO. 6.

Yes. I have been advised by the Bank Board's Office of Finance that it is likely that the bonds as proposed by the U.S. League (the "USL Bonds") would bear interest at a rate 1-1/2% to 2-1/2% greater than the rate for the bonds as proposed by the Treasury and Bank Board (the "Administration Bonds"). The Office of Finance bases its view in part upon the opinions of investment bankers. As I noted in answer to your Question Number 2, the investment bankers have made clear to House Banking the inherent deficiencies of the League Plan.

It is likely that investors would perceive greater risk to be associated with the USL Bonds than that associated with the Administration Bonds. This perception of greater risk would be based on the following considerations:

(1) The USL Bonds, unlike the Administration Bonds, will not be collateralized with respect to principal;

(2) The USL Bonds, which are zero-coupon bonds, will not provide for periodic payments of interest to investors, whereas the Administration Bonds will provide for such periodic payment;

(3) There is substantial uncertainty as to whether there will be adequate resources to assure the timely payment of principal and interest due on the USL Ponds; the Administration Bonds will pay interest periodically and there is substantial certainty that the principal will be paid when due as a result of the collateral that provides defeasance.

(4) The Administration Bond proposal incorporates an interest reserve component of $0.8 billion to provide assurance that interest will be repaid, whereas the USL Bond proposal lacks such a mechanism; and

(5) The USL Bond proposal fails to provide adequate resources to the FSLIC to resolve its caseload of insolvent institutions, and therefore fails to assure investor confidence in the viability of the thrift industry, which will be responsible for making the payments that will support the repayment of principal and interest.

Investors are likely to perceive the USL Bonds as a risky investment, whereas the Administration Bonds are likely to be perceived as low-risk, investment grade investments. Accordingly, investors would demand a higher rate of return on the USL Bonds than on the Administration Bonds.

QUESTION NO. 7 -- Under the Bank Board's recently-issued Memorandum R41c, it has been argued that the Board now has the authority to write down the book value of many loans below that required by generally accepted accounting principles. If so, how does the rule differ from generally accepted accounting principles and why did the FHLBB adopt the rule? Should the rule be modified -- if so, how? Doesn't this put thrifts at a disadvantage relative to competitive depositor institutions who do not have such regulatory requirements? Doesn't it also impair the effort to raise capital levels in thrifts generally?

ANSWER TO QUESTION 7.

R41-c is not an accounting rule. It is an appraisal standard. Accounting rules ("GAAP") do not deal with appraisal standards. All appraisal standards are designed to find the market value of property--generally, real property. GAAP does not set forth a methodology for finding the market value of real estate. R41-c is not a material departure from prior Bank Board appraisal standards. The Bank Board has had similar appraisal standards for a number of years. Those appraisal standards are an embodiment of the best standards of the top professional appraisal groups. They have been praised by Congress. A recent House Committee Report stated: "Among all the Federal banking agencies, only the FHLBB has a highly developed and comprehensive system regarding appraisal policies, practices and procedures."

The commercial banking regulatory agencies also have appraisal standards that find market values in accordance with standard appraisal practices. These agencies use appraisals, as does the Bank Board, to establish the need for loss reserves under their respective classification of assets systems. Therefore, R-41c does not place the thrift industry at a disadvantage relative to banks. For a problem loan (the kind of loan the Bank Board reappraises) for which the only security is real estate, the market value of the property is indisputably the proper value on which to focus.

I have indicated that I intend to ask the Bank Board to put its appraisal standards out for public comment and a possible rulemaking. Similarly, I intend to ask the Board to seek public comment on revisions to our classification of assets system designed to make our system more uniform with that used by the commercial banking regulators. This change would make our system less appraisal driven. I expect to be able to bring these matters before the Board within 30 days. The staff has already issued a clarification of our existing appraisal standards that meets the concerns expressed regarding R41-c.

QUESTION NO. 8 -- An important point was raised by Gerald J. Levy, former Chairman of the U.S. League of Savings Institutions before the Senate Committee on Banking, Housing and Urban Affairs. In his statement he explained that, "experience demonstrates that time can heal wounds -- especially where the institutions involved hold assets consisting primarily of loans secured by real estate." Do you agree with this statement? In other words, is it just a matter of time before the conditions of ailing thrift institutions improves, or are they more or less permanently impaired?

ANSWER TO QUESTION NO. 8.

The institutions in our significant supervisory case list are not improving with time. They are getting worse (and this is considering only net operating losses, excluding all writedowns) at the rate of over $6 million a day, approximately $2.2 billion each year. That is more than FSLIC's entire annual premiums. These institutions are virtually all "bad asset" cases. In addition, these thrifts are the "high rate junkies" who bid up the industry's cost of funds. FSLIC insured institutions have to pay approximately $4 million more in deposit interest rates annually compared to their FDIC insured competitors. They are characterized by very poor under-writing and disbursement practices. These "bad asset" cases are completely unlike the negative spread problems of the early 1980's. Those spread cases involved assets with excellent credit quality, but low interest rates relative to deposit interest rates. When deposit interest rates fell many of these thrifts returned to profitability. No such magic elixir exists for the "bad asset" cases comprising the vast bulk of FSLIC's significant supervisory cases.

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In certain circumstances, forbearance is rational. These special circumstances may exist where (1) temporary regional economic problems cause well-managed institutions with sound underwriting and disbursement practices to suffer losses and (ii) there is a reasonable expectation of near-term economic recovery. Under such circumstances it may be appropriate for the FSLIC to forbear from taking over the institution, provided that (i) the institution has developed a realistic business plan that demonstrates a strong likelihood for the institution's recovery and (ii) the FSLIC has confidence in the ability and integrity of the management of the institution. The Bank Board has developed a forbearance policy that addresses this difficult issue, and this policy is summarized at Appendix B.

QUESTION NO. 9 -- The FSLIC Recapitalization Plan developed by the Treasury Department proposes $10 to $15 billion worth of borrowing, the majority of which is to be raised through the issuance of long term debt. In your opinion, is the thrift industry strong enough to service the interest on this debt over the long term? Furthermore, is it your opinion that the FHLBB has the experienced manpower to efficiently manage this quantity of money?

ANSWER TO QUESTION NO. 9.

A. Ability to Service the Debt of the Financing Corporation

The thrift industry will be able to make the payments necessary to service the interest on the recap bonds. As demonstrated below, we anticipate that the annual debt service will amount to roughly $1.2 billion annually with respect to a $15 billion capital infusion. The Bank Board's staff forecasts that, starting in the early 1990s, the Financing Corporation will be able to service this debt with funds derived exclusively from imposition of the regular 1/12th of one percent assessment on institution deposits.

The interest payments on the bonds will be the obligation of the Financing Corporation. The Administration's FSLIC recapitalization plan authorizes the Financing Corporation to levy regular and special assessments on insured institutions to raise funds for servicing the debt. However, to avoid a double whammy on the industry, the FSLIC's ability to levy assessments is reduced by the amount of assessments levied by the Financing Corporation. Additionally, the Bank Board and Treasury Department support the phase-down of special assessments that is included in the bill on FSLIC recapitalization reported out by the Committee on Tuesday, March 10, 1987.

The annual debt service of $1.2 billion is based upon the following reasonable assumptions. We have assumed that, over a five-year period, the Financing Corporation will issue thirty-year bonds having an aggregate principal amount of $15 billion bearing an average annual interest rate of 8.0%. Assuming further that interest on the bonds will be payable semiannually, the annual interest expense of the bonds would be $1.2 billion during the years 1992 through 2017.

The Bank Board's Office of Policy and Economic Research has conducted analyses that show that, starting in the early 1990s, the Financing Corporation will be able to pay this $1.2 billion amount with funds derived from imposition of the regular 1/12th of one percent assessment on the deposits of the industry. Prior to that time the Financing Corporation will be able to service the interest with funds derived from (i) regular assessments, (ii) special assessments (with the 5-year phase-down supported by the Administration), and (iii) the $0.8 billion interest reserve to be established by the Financing Corporation. By the early 1990s the deposits of the industry are expected to have increased to an amount such that all or a portion of the regular assessments will be sufficient to service the debt.

B. Management of the Funds by the FSLIC Staff

The staff of the FSLIC would be able to employ the funds raised through recapitalization in an efficient and cost-effective manner. My view is based on the abilities of the staff and improvements in operations, and the manner in which the funds will be employed.

We are moving aggressively to improve the FSLIC's ability to use the funds that recapitalization could provide. Last year we requested a comprehensive study of the FSLIC function by Booz Allen and Hamilton, an independent management consultant. The firm concluded that, given current budget constraints for attracting and retaining adequate FSLIC staff, much of the FSLIC case resolution staffing function should be delegated to the Federal Home Loan Banks, with principal oversight and quality control over the function to be assigned to the FSLIC staff and Board in Washington. A system-wide Task Force will present recommendations to the Bank Board within the next few weeks on how to implement the recommendations in the Booz Allen study. The Task Force will address a range of issues including delegation to the regional Federal Home Loan Banks of the staffing for FSLIC case resolutions; the fullest possible use of the Federal Asset Disposition Association (FADA) for both FSLIC asset analysis, and the management and disposition of receivership assets; and the creation of new budget, case planning, cash management, and audit review procedures for FSLIC.

We expect to implement these improvements imminently. I am confident that the measures I have just described will insure the maximum recovery of value for the FSLIC fund by using fully the regional resources of the Federal Home Loan Banks and the organizational expertise of FADA, and by focusing the work of our FSLIC central staff on case planning and budgeting, policy oversight and post-audit review.

The funds that will be contributed to the capital of the FSLIC will be used by the FSLIC to resolve its caseload of troubled institutions in the most cost effective manner. Resolution is accomplished by either (1) liquidating the institution and paying off the depositors or (2) facilitating the acquisition of the troubled thrift by another firm. The FSLIC intends to first focus its resources on hopelessly insolvent thrifts--particularly those with the greater operating losses--so as to minimize the FSLIC exposure in the future.

We fully appreciate the importance of utilizing these resources wisely and effectively. This means that we also recognize the need to make every reasonable effort to see that well-managed, viable thrifts experiencing temporary financial difficulties due to distressed regional economies have the opportunity to recover. To this end, the Bank Board has recently issued a formal statement of its longstanding forbearance policy. Moreover, we welcome the strong Congressional oversight contained in the thrift recovery guidelines reported out by the Committee on Tuesday, March 10, 1987.

QUESTION NO. 10 -- In his statement Gerald J. Levy included cash flow projections for both the U.S. League and Treasury recapitalization proposals. Mr. Levy goes on to explain that, "Our plan provides essentially the same resources to the FSLIC over the next two years as the Treasury's version; it provides signifi-cantly more over the long term because the FSLIC would not be burdened with paying interest on two or three times as much borrowing." Would you care to comment on the apparent differences in cash flow amounts of the two plans?

ANSWER TO QUESTION NO. 10.

The cash flow projections provided by the U.S. League of Savings Institutions (the "League") are seriously flawed, because (i) they use invalid assumptions and (ii) they compare apples and oranges. The flaws in the League FSLIC recapitalization proposal are more fully discussed in my answers to your second and sixth questions (above).

The staff of the Bank Board has prepared realistic pro forma cash flow statements for both the League proposal and the FSLIC recapitalization proposal submitted by the Treasury and Bank Board (the "Administration Proposal"). Summaries of these pro forma cash flow statements are set forth at Appendix C.

A review of the realistic cash flow statements allows one to make the following comparisons:

(1) Contribution to the FSLIC. The Administration Proposal provides the FSLIC with approximately $11 billion more than the League Proposal over the first five years of the plan (exclusive of income from asset disposition and earnings on investments). The

resources provided to the FSLIC (exclusive of income from asset disposition and earnings on investments) under the competing proposals are as follows:

	Administration	League
	(dollars in billions)	
Over first two years:	$ 8.551	$7.522
Over first five years:	19.838	9.616
Over first ten years:	19.992	11.225

(2) Annual Debt Service. The annual debt service for the League proposal bonds is roughly the same as the debt service for the $15 billion of Administration Proposal bonds. Under the Administration Proposal, which provides the FSLIC with $15 billion from the bonds, the Financing Corporation's annual debt service is $1.2 billion. Under the League Proposal, which provides only $5 billion from the bond issuances, the Financing Corporation will be required to annually place $1.15 billion (including FHLBank contributions) in the sinking fund for the zero-coupon bonds.

(3) Special Assessment. Under the League Proposal, the Financing Corporation will be required to reinstitute the special assessment, beginning in 1993, to permit it to make the necessary contributions to the sinking fund for the zero-coupon bonds. Funds from regular assessments and FHLBank contributions will be inadequate to service the annual amount of $1.15 billion.

Under the Administration Proposal, income from regular assessments will not be sufficient to service the interest on the bonds during 1992 and 1993. Nevertheless, it will not be necessary to reinstitute the special assessment to offset the shortfall, because funds from the $0.8 billion interest reserve, provided by the Administration Proposal, will offset the shortfall.

The assumptions underlying our pro forma cash flow statements are as follows:

(1) Interest rate on bonds: 8% for the bonds under the Administrative Proposal and 10% for the bonds under the League Proposal. The reason for the higher rate on the League Proposal bonds, more fully set forth in my answer to your question number 6 (above), was expressed by Mr. Jon S. Corzine of Goldman, Sachs and Co. intestimony before the House Banking Committee on March 3: "Any suggestion that Congress will have to revisit this program in the near future, (i.e. 3 to 5 years)--either because the legislation terminates of its own accord after a few yars or because the legislation fails in some way to firmly and decisively solve the problems it addresses--will have an immediate effect on the investors' willingness to buy the instruments at an appropriate interest rate."

(2) Term on bonds: Thirty years for the bonds under both proposals. See my answer to your question number 2 (above).

(3) Rate of deposit growth: 6%.

(4) Level of assessments: Full regular assessment and phase-down of special assessment as provided in the bill that was reported out of Committee on March 10. 1987.

(5) Federal Home Loan Bank contributions: $3 billion spread over five years under the Administration Proposal. $0.275 billion annually for 30 years under the League Proposal; FHLBank earnings are not expected to increase annually when the FHLBanks are required to make contributions to the Financing Corporation out of their capital on an annual basis.

QUESTION NO. 11 -- In the event the Treasury proposal for FSLIC recapitalization becomes law, will it still be necessary to collect the special assessment now being levied on member-FSLIC institutions?

ANSWER TO QUESTION NO. 11.

Based on the projections made by the Bank Board's Office of Policy and Economic Research, we are of the opinion that the FSLIC will not find it necessary to levy a special assessment on FSLIC-insured institutions in the immediate years following the phase-down of such assessments incorporated into the version of the recapitalization plan reported out by the Committee on Tuesday, March 10, 1987. This is not to say that the FSLIC will never again exercise its special assessment authority. However, assuming that the Administration's FSLIC recapitalization proposal is enacted, barring unforeseen changes in the economic condition of the thrift industry, it is unlikely that the FSLIC would be required to exercise its special assessment authority at any time in the immediate future following the phase-down of those assessments.

It should be noted that if the FSLIC is not recapitalized, the FSLIC will be required to continue to impose the maximum special assessment indefinitely.

QUESTION NO. 12 -- Speaking for the National Council of Savings Institutions, Robert S. Gaiswinkler noted that, "Given the administrative burdens already facing the FHLBB as the chartering agency of federal thrifts, regulator of S & L holding companies and operator of the Federal Home Loan Mortgage Corporation, perhaps the time has come to restructure the FSLIC more along the lines of the independent FDIC. For example, operating control over the monies raised by the Financing Corporation could be vested in a public/private board composed of diverse government officials. The FDIC, for example, has an employee of the Treasury, namely the Comptroller of the Currency, serving on its Board." We would appreciate any comments you may have regarding this idea.

ANSWER TO QUESTION NO. 12.

I am vehemently opposed to the idea of removing the Federal Home Loan Bank Board from the control of the FSLIC. The way I look at it, "if it isn't broken, don't fix it". The above statement of Mr. Gaiswinkler suggests that the three member board that operates the Federal Home Loan Bank Board is overtaxed with its various responsibilities. Quite bluntly, I disagree with this suggestion. Moreover, as explained in my testimony to your committee on January 21, 1987, improvements in the staffing and operations of the agency, especially after implementing the recommendations of the Booz-Allen study and the FSLIC Restructuring Task Force, prepare the FSLIC to effectively perform its responsibilities. Additionally, for the reasons set forth in my response to your third question (above), I believe that it is sound policy for the Bank Board to serve as the agency responsible for the safe and sound operation of federally chartered thrifts as well as the agency responsible for the safe and sound operation of all federally insured thrifts.

EXHIBIT A

APPENDIX REGARDING DIRECT INVESTMENT STUDIES

The following summarizes various studies conducted by the Office of Policy and Economic Research ("OPER") of the Bank Board and by others regarding direct investment activity by FSLIC-insured institutions. Studies discussed in the body of the answer to Question No. 4 are not addressed herein.

The McKenzie-Bisenius (86) Study

Various studies conducted by the OPER indicate that substantial direct investment involvement by thrifts generally exacerbates the problems of the thrifts and adds to the losses ultimately borne by the FSLIC. I am aware, however, that studies conducted by Prof. George J. Benston suggest that direct investments have been profitable for 18 of the 21 institutions that were the subject of his case studies. The Bank Board's staff conducted an independent study of those same institutions as well as 16 others, which, in December 1983, had direct investments in an amount exceeding 10 percent of their assets.[1] The staff study indicates that, of these 37 institutions, 21 have failed, become FSLIC cases, or are considered significant supervisory cases by the Office of Regulatory, Policy, Oversight and Supervision ("ORPOS").[2] Ten of the 21 institutions are currently in the FSLIC caseload. They have assets of $6.3 billion and the estimated cost to the FSLIC to resolve them is $2 billion. The current return on assets for these ten institutions is a negative 1007 basis points. Another eight of the 21 cases are in the FSLIC's significant supervisory caseload. These institutions have assets of $3.75 billion and the FSLIC estimates the cost of resolving them will be approximately $1.2 billion. These eight institutions currently have a negative return on assets of 408 basis points.

Finally, three of the 21 institutions referred to above have been closed by the FSLIC. These three institutions had assets of $703 million and the cost of resolution to the FSLIC was approximately $350 million. These 3 institutions had, at the time of closure, a negative return on assets of 916 basis points. In June, 1986, the other 16 institutions in the study had an average return on assets of 30 basis points, which was far below the average return on assets of 108 basis points for 79% of the industry.

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[1] See Memorandum for Robert Sahadi from J. McKenzie and D. Bisenius Re: Performance of Institutions with Direct Investments Above Ten Percent of Assets in December 1983 (October 31, 1986) (hereinafter "McKenzie-Bisenius (86) Study").

[2] A failed institution is one in which FSLIC action has been taken to resolve an insolvency. A FSLIC case is an institution currently under consideration by the FSLIC for final resolution. Generally, a significant supervisory case is an institution determined by the ORPOS to be 6-12 months from insolvency. These two catergories are collectively referred to as herein "problem cases".

In a 1987 study,[3] Professor Benston attempted to refute the McKenzie-Bisenius (86) Study. He contended that his review of the financial statements of the 21 problem cases indicated that direct investments mitigated rather than imposed losses on the FSLIC for the insured institutions that failed or are considered to be significant supervisory cases.

The Bisenius-Sahadi (87) Study

As part of its ongoing research, the OPER conducted a two-part follow-up study on the McKenzie-Bisenius (86) Study.[4] The first part of the study compares the average performance of the group of 37 with the industry's average performance and with the average performance of institutions from the respective state(s) of the group of 37. The results indicate that while the group of 37 had significantly more direct investments than the industry in 1983, their average net-worth ratios and profitability ratios were not significantly different from the industry's average ratios. By 1986, however, the remaining 31 (6 had failed) had significantly lower net-worth ratios and profitability ratios. Comparing the performance of the California institutions from the group of 37 with the rest of the California institutions gives similar results. The other subgroups did not significantly deviate from their respective peer groups.

The second part of the Bisenius-Sahadi (87) Study summarizes the case studies of the 21 institutions (out of the original 37) currently characterized as problem institutions. Benston had argued "that direct investments (in these institutions) mitigated rather than imposed losses on the FSLIC." The case studies, however, suggest that in at least 16 of the 21 problem cases, direct investments contributed to FSLIC's losses. For example, in one institution where the Benston (87) Study claimed that direct investments benefited the institution, the Bisenius-Sahadi (87) Study documents that the institution had losses of $5.6 million (estimated) on its $15 million of direct investments. In another case where the Benston (87) Study claimed that direct investments benefited the institution, the FSLIC stands to lose $58 million on a $115 million direct investment portfolio. In only one of the 21 institutions did direct investments appear to reduce the FSLIC's losses. The total expected losses to the FSLIC from direct investments in these 21 institutions is conservatively estimated at between $.5 billion and $1 billion.

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[3] See Benston, Direct Investments and Losses to the FSLIC, (Feb. 13, 1987) (hereinafter "Benston (87) Study").

[4] See Memorandum for the Board from D. Bisenius & R. Sahadi Re: A review of the Performance of Institutions with Direct Investments Greater than Ten Percent of Assets in December 1983 (Feb. 12, 1987) (hereinafter "Bisenius-Sahadi (87) Study").

Thus, in contrast to the Benston (87) Study assertion, the projected losses resulting from direct invest-ments suggest that direct investments significantly contributed to the problems.

In the Board's view, the results of the McKenzie-Bisenius (86) Study and the Bisenius-Sahadi (87) Study support the Board's concern that high concentrations of direct investments may be associated with an increased risk of financial difficulties. The studies do not demonstrate that direct investments automatically cause failures, because statistical studies cannot demonstrate causality. Nevertheless, the Board believes that they offer persuasive evidence that a supervisory review process is justified where an institution wishes to exceed a certain threshold in direct investments, and that such a review process serves to reduce the risk of loss to the FSLIC.

The Hjerpe (86) Study

Some institutions contend that the problems associated with direct investment are really reflective of broader regional problems, such as the present economic difficulties in Texas, and are not indicative of the attributes of all direct investments. In order to isolate the regional distress problems from the problems associated with direct investment, the OPER reviewed in December, 1986, the performance of California state-chartered, FSLIC-insured institutions that had direct investments in excess of five percent in December 1983.[5] The Hjerpe (86) Study focused on California thrifts because the state of California has one of the most liberal laws regarding direct investment and it has not suffered regional economic distress, as have certain other states with liberal direct investment laws.

The results of the Hjerpe (86) Study indicate that, of the 33 institutions that held greater than 5 percent of assets in direct investments at year end 1983, 20 are now problem cases. The estimated cost to the FSLIC to resolve these 20 institutions is over $3 billion. In December, 1983, the average ratio of regulatory capital to liabilities for the 33 institutions was 3.08 percent; in September, 1986, that ratio had decreased to a negative .304 percent.

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[5] *See* Memorandum for Robert Sahadi from E. Hjerpe Re: Status of California Thrift Institutions that held Direct Investments or ADL Loans on December 31, 1983 (Dec. 17, 1986) (hereinafter "Hjerpe (86)").

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM GEORGE D. GOULD

Question 1

In September of 1984, the Senate passed a comprehensive banking bill authored by Senator Garn. It provided bank holding companies with new securities powers and closed the nonbank bank loophole.

Would you support the passage of a bill like the one we passed in 1984?

Answer

The 1984 bill passed the Senate near the close of the session after many months of hearings and legislative drafting. This year there is an urgency for financial assistance to the Federal Savings and Loan Insurance Fund that makes it imperative that Congress act on our FSLIC recapitalization bill as soon as possible. I believe that much of 1984 legislation will be too controversial to pass the Senate expeditiously. Consequently, the FSLIC bill should be taken up and enacted immediately. We need to bolster the resources of the FSLIC and maintain public confidence in the Fund and in the savings and loan industry.

When this has been done, Congress can turn its attention to the other important financial institutions legislation on its agenda. The Administration stands ready to work closely with Congress to modernize our financial system.

Question 2

In June 1985, when Secretary Baker testified before our Committee, I asked him whether the Administration wanted bank holding companies to engage in a wide variety of new activities. He said that while he favored the four powers about which I asked you to testify, the Administration did not support giving banks insurance brokerage powers, or real estate brokerage and development powers. Is that still the case?

Answer

It has become more and more apparent to us over time that all financial service providers are going to need a wide range of service authorities in order to be effective competitors in the current and future marketplace. Whereas not very long ago the extension of a short list of new activities to banking organizations may have been an optimal starting point for the restructuring of our financial institutions, that seems much less the case today. The pace of financial innovation has been much too rapid for us to focus only on those additional powers encompassed by mutual funds, commercial paper, mortgage-backed securities and municipal revenue bonds. For example, in just the past year securitized consumer loans have become an important element in the investment portfolios of some financial services providers. Moreover, there is every reason to believe that additional innovative products will continue to come to market to the detriment of overly regimented institutions, especially our traditional depositories.

The safety and soundness of our financial system will ultimately be based upon the ability of the system to attract capital. The required capital will be attracted to the system if reasonable profitability can be maintained in the face of various economic and financial market events. This means that the management of financial organizations must have the discretionary ability to alter the composition of services offered and investments made according to their own competitive strengths, not regulatory fiat.

For similar reasons the arguments of the opponents of nonbank banks have also been misplaced. It simply has not been demonstrated that these institutions undermine the safety and soundness of the banking system. The owners of nonbank banks are typically well-capitalized firms that should strengthen, not weaken, the banking system. Moreover, nonbank banks can be expected to enhance competition and consumer welfare as they bring to bear in the financial marketplace the marketing expertise and economies of scale of their strong and sophisticated owners. In addition, over twenty years of experience with unitary thrift holding companies has demonstrated that abusive credit practices, unfair competition, and undue risk to the payments system and federal deposit insurance do not necessarily flow from affiliations between commercial and banking entities.

On balance, I would much prefer that a "clean" FSLIC recapitalization bill be acted on at the earliest possible date. Funding FSLIC is the single most urgent "banking" measure before the Congress at the moment. Following that, we should open anew the debate over financial restructuring. This debate should focus on the many new proposals being put forth by parties such as the Federal Reserve Bank of New York, the Association of Bank Holding Companies, the Mayflower Group, and others.

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Proxmire -- Gould

Question 3

Last March you testified that you would oppose closing the nonbank bank loophole unless it was done in the context of a comprehensive banking bill. The bank powers you specifically stated should be in such a bill were mutual funds, mortgage-backed securities, commercial paper and revenue bonds. You said you didn't advocate the total dismantling of Glass-Steagall and did not advocate giving banks the power to underwrite equity securities.

If I presented this Committee with a bill to close the nonbank bank loophole and coupled it with the four additional banking powers you advocated last year, would the Administration support that effort? If not, why not -- what other powers for banks would you want in such a bill?

Answer

See answer to Question 2.

Question 4

On January 12, Secretary Baker made a speech at the opening of the Garn Institute and urged further deregulation of the financial marketplace. He noted that consumers "like to have consumer banks or other companies offering special service or better terms for their credit and transaction business."

Some critics, however, claim that so-called consumer banks are essentially a device for breaching the Congressionally established wall that now separates banking and commerce. They ask whether we really want a retail business to be able to gather deposits under the protection of federal insurance and to use those deposits to fund credit cards more cheaply than their retailing competitors? Are there not also risks, they ask, in reducing credit standards in an effort to expand nonbanking business?

How do you respond to such critics?

Answer

See answer to Question 2.

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Proxmire — Gould

Question 5

Some advocates of keeping the nonbank bank loophole open argue that the relationship between a bank and its commercial affiliates could be so closely regulated that the safety and [illegible] Do you believe that the banking portion of a commercial company could be effectively insulated from the failure of its parent company, or that a bank holding company could be insulated from the failure of its commercial subsidiaries?

Answer

My views on the benefits of holding company separation are consistent with those expressed by the Administration in testimony during the last three Congresses. I believe the banking portion of a commercial company can be effectively insulated from the failure of its parent company or affiliates by a requirement that nonbanking activities be conducted outside of the bank and its direct subsidiaries. The holding company could be an important source of capital to the bank.

The overall organization would benefit from earnings diversification, enhanced competitiveness, and the opportunity to attract and retain customers with diversified products. The insured depository, however, would be fully insulated from any risks undertaken by nonbanking affiliates because those affiliates would not be assets of the bank and appropriate restrictions could ensure separation in the mind of the public. The insured deposit gathering function of a bank can be insulated and protected from weaknesses in other affiliates in a holding company.

Question 6

Last June Chairman Volcker testified that if the nonbank loophole is not closed, it will be much more difficult to interest banks or other companies to take on the heavy capital and management burden of acquiring large troubled thrift institutions and thus would limit any non-government contribution to easing the burden on the FSLIC.

Do you agree? If not, why not?

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Proxmire -- Gould

Answer

I doubt seriously that closing the so-called nonbank bank loophole would help FSLIC significantly. The Administration has presented a recapitalization plan to Congress to assist FSLIC and that should be our first, common priority.

The benefits which flow to the public from the presence of consumer banks are quite real. Americans are seeking a financial system that serves their economic needs and meets their requirements for safety, convenience, and diversification. As I indicated in my testimony, consumer banks have been around for years in various forms; none has gotten into serious financial trouble, let alone precipitated a financial collapse as some have predicted. We should not close down these new opportunities for consumers and commerce simply for the sake of aiding FSLIC, especially when we have initiated a plan that is based on industry self-help and avoids taxpayer assistance.

In some marginal situations it may be true that an institution wishing to enter the financial services field, or to expand or diversify its existing financial services business, may acquire a troubled thrift if the option of establishing a nonbank bank were unavailable. In my opinion, however, these two types of financial institutions are currently sufficiently distinct as to not constitute "perfect substitutes" for the majority of potential acquirers.

While nonbank banks may offer freedom from geographic restrictions, in most other respects they are a more restricted type of organization than are thrifts which offer significant advantages in terms of service powers (service corporations included), regulatory standards, and central bank borrowings (FHLBB advances). It is not entirely clear, therefore, that a business organization wishing to offer a financial services program encompassing the major attributes of thrift institutions would find the nonbank bank an acceptable alternative.

If this is true, closing the nonbank bank loophole would do little to alter the level of acquisitions of thrifts beyond what it would have been with the loophole intact. To argue otherwise would be to transfer a carefully planned resource commitment from a top priority to a lower priority investment. In more cases than not, that investment would simply not be made.

Question 7

Does the Federal Home Loan Bank Board currently have authority to impose exit fees on institutions that leave the FSLIC and obtain FDIC insurance?

If not, should it be granted such authority?

Answer

Yes. I believe that the FSLIC has the authority to charge exit fees. Section 407(d) of the National Housing Act (12 U.S.C. 1730(d)) states that in the event of termination of FSLIC insurance, a thrift must, within 30 days of such termination, pay as a final insurance premium a sum equivalent to twice its last insurance premium. This may constitute an "exit fee."

Nevertheless, I believe that Congressional interest in action on the exit fee issue is appropriate for several reasons. First, there is an equitable justification for charging S&Ls leaving FSLIC a fee to compensate the insurance fund for inadequate payments in prior years. These S&Ls received insurance coverage from a system that only now is paying the built-up costs of that insurance; it is only fair that these institutions pay a share of the costs accrued when they were FSLIC-insured. Second, the industry, the FHLBB, and the capital markets would benefit from an increased degree of certainty about the amount of an exit fee. Third, an exit fee would reassure the S&L industry that the 1/8 of one percent special assessment can be reduced and eliminated on schedule and will not need to be reimposed. The second and third points also have the benefit of reducing uncertainty for investors considering putting capital into the industry -- which is an important approach to enhancing the industry's long-term strength.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM GEORGE D. GOULD

Question 1

You commented in response to a question posed during the hearing that you believe approximately 15 percent of the savings and loans could convert to savings banks, thereby switching to FDIC insurance. Could you provide the numbers on which those approximations are based and provide some assessment of what percentage of those thrifts you feel would be motivated under each of the two recapitalization plans to switch to FDIC insurance? What do you believe the prime factors motivating a thrift to make that switch are and what are the prime deterrents?

Answer

The Federal Home Loan Bank Board has determined that 1,096 institutions holding 15 percent of the thrift industry's assets are capitalized adequately and hold an asset portfolio that would allow these institutions to meet the requirements of both insurance corporations regarding thrifts switching from the FSLIC to the FDIC. For example, the FSLIC would require thrifts to pay back their FHL Bank advances (with a prepayment penalty) and to pay an exit fee. In addition, the FDIC would require such institutions to have between five and six percent GAAP net worth and to be divested of certain assets not permitted by the FDIC, like direct investments.

It is not possible to know the number of institutions that will actually switch and how these numbers would differ under the two proposed recapitalization plans. However, the incentives for switching under the two plans are very different and would make switching more attractive under the League's plan. Although the costs to thrifts themselves under the two plans are nearly the same, the costs to the FHL Banks are much higher under the League's plan. Therefore, thrifts that depend upon the FHL Banks for advances and other services (which would be curtailed or be made more expensive as a result of the League plan's drain on the FHL Bank System's surplus) may be more likely to switch if the League's plan, rather than the Treasury/FHLBB plan, is adopted. In addition, the high cost the League's plan imposes on the FHL Bank System will likely make it necessary for the special assessment to be reinstated on the industry.

The major incentive thrifts have for switching to the FDIC is the increase in stock value resulting from such a switch. For example, a well-capitalized thrift's stock value can increase 20 to 100 percent because commercial banks are worth more in the market, branch networks are worth more in the banking industry, and because the capital markets continue to view thrifts as interest rate risks, regardless of any individual thrift's portfolio. Certainly, thrifts dislike the special assessment, but this additional insurance cost has not been shown to be a major factor in the decision-making processes of those thrifts that have switched to the FDIC.

Deterrents to switching to the FDIC are both technical and substantive. Technical deterrents include legal costs, exit fees, and the prohibition against federally chartered thrifts switching to the FDIC (federal institutions would have to become state-chartered before they could switch insurance corporations). Although these factors represent hurdles to be jumped in order to switch, the powers that thrifts would have to give up in order to switch represent the greatest deterrents. In addition to giving up direct investments, thrifts would incur more stringent capital requirements, reserve requirements, and other regulations; thrifts could lose membership in the FHL Bank System; and multi-thrift holding companies would not be permitted. That FSLIC insurance is attractive is shown by the fact that at least eight institutions switched from the FDIC to the FSLIC in 1986. This demonstrates that there are substantial advantages to having FSLIC insurance and that these advantages outweigh the costs (e.g., special premiums and exit fees).

Question 2

You spoke in favor of an exit fee for thrifts leaving the FSLIC insurance program. Please explain how you believe any such exit fees should be applied and how the amount of the fee should be determined. Should an exit fee requirement be added to any FSLIC recapitalization plan enacted by the Congress? How would the application of an exit fee alter your estimates of the number of thrifts that are likely to switch over to FDIC insurance?

Answer

First, I should stress that an exit fee is not essential to the financial integrity of our FSLIC recapitalization plan. Our plan provides a number of cushions to ensure viability, including an "interest reserve" of at least $800 million in the Financing Corporation (preserved from the original FHL Banks' investment). Also, Federal Home Loan Bank Board analyses have shown that at least 15 percent of the thrift industry's assets could leave the FSLIC while leaving it with positive reserves and without requiring any change in the phase-out of the special assessment.

Second, I believe that the FSLIC currently has the authority to charge exit fees. Section 407(d) of the National Housing Act (12 U.S.C. 1730(d)) states that in the event of termination of FSLIC insurance, a thrift must, within 30 days of such termination, pay as a final insurance premium a sum equivalent to twice its last insurance premium. This may constitute an "exit fee."

However, I believe that Congressional interest in action on the exit fee issue is appropriate for several reasons. First, there is an equitable justification for charging S&Ls leaving FSLIC a fee to compensate the insurance fund for inadequate payments in prior years. These S&Ls received insurance coverage from a system that only now is paying the build-up costs of that insurance; it is only fair that these institutions pay a share of the costs accrued when they were FSLIC-insured. Second, the industry, the FHLBB, and the capital markets would benefit from an increased degree of certainty about the amount of an exit fee. Third, an exit fee would reassure the S&L industry that the 1/8 of one percent special assessment can be reduced and eliminated on schedule and will not need to be reimposed. The second and third points also have the benefit of reducing uncertainty for investors considering putting capital into the industry -- which is an important approach to enhancing the industry's long-term strength.

Depending on one's view of the equities and the weight of the other two factors, the size of an exit fee that might be considered appropriate ranges from a low of 0.22 percent of deposits to a high of 1.30 percent of deposits. The low fee would represent the present value of two years of the scheduled declining special assessment on a static deposit base, and exclude the regular 1/12 percent premium on the argument that another insurer will have to be paid the same amount. The high end would represent the present value of the declining special assessment and ten years of regular premiums, with both assessed on a growing insured deposit base. Values in between would depend on one's selection of time frame, deposit growth rate assumption, discount rate, and inclusion or exclusion of the regular premium. In addition, I believe it would be appropriate, particularly for higher levels of exit fees, for the exit fee to include a sliding scale that would be lower the later one left. Another item that would be equitable to include is the requirement that institutions which leave FSLIC should end their membership in the Home Loan Bank System (without affecting current FDIC members of the FHL Banks).

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Sanford -- Gould

I do not believe that an exit fee will induce thrifts to switch from the FSLIC to the FDIC. As I stated in our answer to your first question, exit fees do not figure significantly in the decision of a thrift to switch to the FDIC and the advantages of FSLIC insurance outweigh the cost of any exit fee.

Question 3

In response to a question regarding the merger of the FSLIC and the FDIC, you commented that there is a great deal of confusion as to what is meant by a merger. Could you define exactly what you mean by a merger, what regulatory changes such a merger would entail, and how any such merger would affect the current plans to recapitalize the FSLIC?

Answer

The Treasury is committed to recapitalizing the FSLIC and getting the thrift industry back on its feet without merging the FSLIC with the FDIC. In the event that the FSLIC is not recapitalized, however, we support merging the two insurance corporations because it would avoid the need for the taxpayers to save the thrift industry, and it would bolster public confidence in the deposit insurance system.

Merging the FSLIC with the FDIC would require more than simply commingling their respective reserves. Given the fact that the FSLIC has the problems and the FDIC has the assets, a merger would mean the imposition of commercial bank regulatory standards on the thrift industry. As mentioned in my answer to your first question, the FDIC would require thrifts to hold reserves and to divest themselves of certain assets (e.g., direct investments). The phase-in of these and other changes would be time-consuming and extremely complex. Consequently, Treasury prefers to recapitalize the FSLIC as soon as possible and restore public confidence in the thrift industry.

Question 4

In your testimony, you express both a strong concern for the thrift industry and strong support for nonbank banks. Others have stated that the existence of the nonbank bank loophole sharply reduces the number of purchasers willing to buy an ailing thrift. Do you agree with that proposition and if so, how do you reconcile your support for nonbank banks with the need to encourage the acquisition of ailing thrifts?

Answer

See answer to Proxmire Question #6.

Question 5

In your testimony, you state "an active secondary market in home mortgages moves billions of dollars around the nation, reducing and equalizing rates in an efficient manner, greatly assisting homebuyers by making more credit readily available." Do you believe your statement would change if the plans to "privatize" Freddie Mac, Fannie Mae, and Ginnie Mae were implemented?

Answer

As a purely technical matter the "privatization" of Freddie Mac, Fannie Mae and Ginnie Mae should not have a significant detrimental impact on the secondary mortgage market. These institutions are perceived currently by private competitors as having some market advantage due to their ability to borrow funds at some marginal advantage because of their relationship to the Federal Government. But in all other respects private participants in the secondary market are equally equipped to create pools of insured mortgages against which standardized and guaranteed securities can be issued. On balance, if these agencies were to be privatized it is unlikely that the efficiency of the secondary mortgage market would be impaired, although there might be a slight increase in mortgage financing rates due to the elimination of the financing subsidy that currently adheres to the federally affiliated institutions.

As a practical matter, however, there appears to be little likelihood of privatization of any of the housing-related agencies. For example, in January of this year, the Task Force on the Future of the Federal Housing Administration recommended against the privatization of that agency, while in early February of this year a similar task force recommended against the privatization of Freddie Mac.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GRAHAM FROM GEORGE D. GOULD

Question 1

Mr. Gould, what impact do you think the declining dollar has on the U.S. banking system?

Answer

Although banks do take positions in foreign exchange, I do not believe that a decline in the dollar impacts negatively on the safety and soundness of the U.S. banking system. The impact on the banking system varies, but some generalizations are possible. The capital, liability and asset base of some foreign banks have appreciated relative to U.S. banks when translated into dollar terms. (Alternatively, the capital, liability and asset base of U.S. banks have decreased relative to foreign banks if translated into the domestic foreign currency). This shifts the relative international standing of U.S. banks (down) and foreign banks (up) in the international league tables that usually are measured in dollars.

To the extent that U.S. banks have diversified overseas (or domestic) operations that earn foreign exchange, these translate into higher dollar earnings and profits. They are a source of support. If foreign borrowers' debts are denominated in dollars, but some of their earnings are in currencies that have appreciated against the dollar, their cash flow and earnings translated into dollars improves, and so too should their ability to repay their dollar debt.

For U.S. banks, to the extent a lower dollar makes U.S. firms more competitive, the dollar earnings and balance sheets of these domestic clients should improve.

A lower dollar also could make the banks' own stock and bond issues more attractive to foreign investors. Conversely, the lower dollar would make investment and capital-related operations in some overseas countries more expensive for U.S. banks.

Question 2

Mr. Volcker discusses the international forces at work in the banking and financial market place. Would you state what you see these forces as being today?

Answer

Domestically, I see a deepening and broadening of our financial markets. Established institutions such as savings and loan associations and commercial banks are expanding nationwide while less regulated financial intermediaries are becoming financial department stores or conglomerates. There has been an explosion of new products and services in the last few years that are revolutionizing the way consumers do their financial business. New technology and a new generation of consumers with different tastes and needs have fostered this revolution. I expect the proliferation of new products and services to continue, and I see new vendors emerging to take advantage of opportunities in the financial marketplace. Most important, I see consumers enjoying a modern financial system with easier access to more and varied financial services.

Internationally, I see an increased interconnection of the world's major financial markets. Large financial firms are expanding their international activities to make them an integral part of one market operating over different time zones. Efforts are being made to standardize the way markets operate, the principal products and services offered and the structure of regulation. Financial practices and financial instruments common to a few national markets are being redesigned for use internationally. Financial institutions in many countries are being authorized to conduct new activities to make them more competitive with firms in other countries also operating in the global market. To coordinate and supervise these changes on behalf of the public, major regulators like the Federal Reserve and the Bank of England have been working to develop common regulatory standards and, in the case of the Securities and Exchange Commission, to help structure abroad regulatory procedures and mechanisms similar to those in the United States where securities markets are already more elaborate.

Question 3

What do you think is our internationally competitive position today? Will the changes proposed at these hearings help the U.S. competitive position?

Answer

I think our competitive position in financial services is mixed. In some respects, we are at the forefront of developments taking place abroad and are one of the principal innovators. But in other instances we are lagging behind the progress in foreign markets, because our major financial institutions, commercial banks, have limitations on their activities that impede their full participation in the global market.

The Administration's recommendations for financial reform and the kinds of general financial services restructuring proposals being discussed in these hearings could help our competitive position in world financial markets a great deal, if they materialize in legislation. We have been discussing some of these reforms for years and its time that something truly significant was done to modernize financial institutions legislation.

While our plan to recapitalize the Federal Savings and Loan Insurance Corporation Fund is primarily a domestic proposal, it also has important international ramifications. We need the recapitalization to demonstrate the viability of a major sector of our financial services industry and to indicate our determination to maintain confidence in federally-insured depository institutions. This is significant in that the Federal Home Loan Bank System is now raising some of its funds in foreign markets.

Beyond FSLIC recapitalization I look forwarded to working with Congress to remove some of the restrictions on bank holding companies to make them truly financial service organizations. It is time to examine ways to make financial service firms and other vendors of financial services as efficient as possible in serving consumers. We need to look at the best way to make the holding company structure flexible for all types of depository institutions and to make it adaptable to future innovations in financial products and services.

Question 4

On page 12 of your statement you urge the Committee to authorize the Federal Reserve Board to allow bank holding companies to engage in "activities of a financial nature". What do you mean? What do you see these as being?

Answer

The activities of a financial nature that the Administration would like holding companies to be able to enter will depend on future developments in the financial services industry. By giving the Federal Reserve Board the authority to determine appropriate new activities, Congress would provide the industry with the flexibility to be competitive with nonregulated financial institutions. The "financial nature" standard is much broader than "closely related to banking and a proper incident thereto" under current law or even the "closely related to banking" standard the Senate passed in 1984 as part of S. 2851 (which directed the Fed to take into account technological or other innovations in the provision of banking or banking related services). As holding companies seek permission to offer other financial services that are developed by the marketplace, the Federal Reserve Board should be encouraged (or directed) to permit activities that would promote competition among all companies, whether or not depository institution holding companies, engaged in financial activities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
GEORGE D. GOULD

Question 1

The Federal Reserve has on several occasions voiced its concern that affiliations between banks and non-banking firms, especially securities firms, might pose grave risks to the inter-bank payment system. Is there any way of insulating banks from their affiliates so that the payments system and bank capital will not be put at risk by the activities of affiliates?

Answer

The Federal Reserve's major concern with the payments system has been the risk posed by participants in the large dollar electronic payments networks such as FedWire and CHIPS. Transfers via these networks are effectively irreversible upon receipt, thus putting the Federal Reserve and other participants at risk of loss should the sending institution be unable to meet its payment obligation. The Federal Reserve is especially concerned about the large volume of daylight overdrafts -- averaging about $40 billion per day -- that facilitate fund transfers via FedWire. The small dollar payments networks associated with automated clearing houses (ACHs) retail electronic funds transfers (EFT), and checks are not of major concern in this respect.

The Federal Reserve, via a system of "net debit caps", currently restricts the amount of an institution's overdrafts by limiting them to a maximum of three times capital on a single day and a daily average of two times capital per two-week period. Furthermore, current Federal Reserve proposals would reduce that overdrafting capability by 25% effective June 1987 by decreasing the net debit caps to two-and-a-quarter times capital per day and an average of one-and-a-half times capital per two-week period. Over an extended period of time the Federal Reserve would like to reduce the daylight overdrafts on FedWire to a truly negligible amount. Simply put, the Federal Reserve is moving toward wringing out most, if not all, of the risk in the payments mechanism.

Nevertheless, the Federal Reserve is fearful that in times of "stress" the unregulated parent of a depository institution (e.g., a securities firm with a nonbank bank affiliate) might "force" the depository to transfer funds via FedWire which could not be made good. For this type of situation, the Federal Reserve has argued that only a "real time" monitoring capability would enable the System to control risk. In a June 1986 submission to the Subcommittee on Commerce, Consumer & Monetary Affairs of the Committee on Government Operations of the United States House of Representatives, the Federal Reserve indicated that: "real time monitoring of a depository institution's accounts and rejection or delay of transactions that would create overdrafts would address the problem of overdrafts in times of stress...." Furthermore, the Federal Reserve stated: "all the Reserve Banks are scheduled to have an automated capability by March 1987."

Like the Federal Reserve, Treasury views the safe and sound operation of the payments system as an absolute necessity. For one thing, it must be understood that any losses incurred by the Federal Reserve should it need to "make good" a funds transfer initiated but not covered by the originating institution is a cost passed through to the Treasury in the form of a lower Federal Reserve payment to the Treasury at the end of the year. Also, any payments system failure that resulted in the systemic failure of depository institutions or the collapse of the government securities market would be of major consequence to Treasury. In the first case, Treasury might be called upon to support the federal deposit insurance funds; in the second case, Treasury might be unable to raise needed funds on a timely and cost effective basis.

On balance, however, I do not give much credibility to the allegation that nonbank banks pose undue risk to the payments system. To the extent that nonbank banks do become more significant participants in the high risk components of the payments system in the future, it would seem that measures already taken by the Federal Reserve, and measures proposed for the future, would be more than adequate to mute unique concerns about nonbank banks. Nevertheless, I did not object to the provision in last year's bill (S. 2592) that would have extended the provisions of Section 23A of the Federal Reserve Act to the transactions between a nonbank bank and its unregulated parent holding company or affiliates thereof, specifically including overdrafts.

Question 2

The banking industry, including the small banks, is facing increased pressure from competitors which have greater flexibility to respond to a dynamic market with products like the securitization of car loans and the securitization of consumer credit receivables. Do you see any way in which we can keep our banking system healthy and competitive without substantially altering the current regulatory structure to permit full competition among the financial services providers?

Answer

In my opinion the era of highly regimented and segmented financial services providers already has passed. Recent history has shown that nondiversified financial institutions run an inordinate risk of potential failure -- be they thrifts concentrated in real estate or commercial banks concentrated in petroleum or agricultural loans. Once problems appear in such institutions, investors will not be forthcoming to provide that additional capital needed to avoid failure, largely because that capital will be limited to the support of activities already proven to be of questionable economic viability. The reluctance of private investors to place yet more capital at risk in highly regimented institutions is the primary reason thrift and bank failures have reached record proportions.

Significant reform of the current regulatory structure is needed to permit all financial services providers the flexibility to diversify their activities in accord with their perceived competitive advantages. Such risk diversification will strengthen the overall institution, reduce the likelihood of financial difficulties when one facet of operations suffers a downturn, and allow a financial institution's management the discretionary ability to restructure its portfolio from unprofitable to profitable activities as dictated by economic and financial market events. This will ensure that the institution will be able to attract capital necessary for continued safe and sound operation.

Question 3

The capital raising mechanism in this country is becoming increasingly centered in New York. Wouldn't it make sense to improve the capital-raising abilities in other areas of the country by permitting the banking system, under proper regulation, to compete in this market?

Answer

Allowing banking organizations more freedom to compete in the capital markets would enable other areas of the country to compete more effectively with New York as major financing centers. Although the largest New York banks would be among the likely new entrants, other major banks -- for example in California, Illinois and Pennsylvania -- undoubtedly would be major competitors in these markets. This would enhance competition, benefit local economies, provide greater convenience to customers, facilitate access to local funding, and produce more efficiency and diversity in the capital raising process.

Question 4

Does the high degree of concentration which currently exists within the investment banking industry and excessive profits earned by those firms, cause any concern that there needs to be greater competition in those markets? Wouldn't banks and other financial services providers be natural entrants in that market? If U.S. banks are prohibited from entering, isn't it more likely that instead of losing market shares to U.S. banks, securities firms wil~~l inste~~ad lose shares to foreign securities firms and foreign financial intermediaries?

Answer

Enhancing competition has been one of the Administration's principal arguments for allowing banks to enter the securities field. Securities industry profits are cyclical and the industry happens to be doing well in the current environment. The industry also is highly concentrated, so there are opportunities for very large profits. Certainly if banks are given new securities authority, which I believe is a natural extension of their existing commercial lending, securities brokerage, and portfolio investment functions, the enhanced competition would benefit banks as well as their customers. To the extent foreign securities firms seek to become a bigger presence in U.S. markets, they will reduce the market share of domestic securities firms even more if domestic banks continue to be excluded. Now is the time Congress should be seeking ways to make U.S. financial intermediaries more competitive in global markets.

Question 5

In his statement before the Senate Banking Committee (1/22/87) Gerald J. Levy included cash flow projections for both the U.S. League and Treasury recapitalization proposals. Mr. Levy goes on to explain that, "our plan provides essentially the same resources to the FSLIC over the next two years as the Treasury's version; it provides significantly more over the long term because the FSLIC would not be burdened with paying interest on two or three times as much borrowing." Would you please comment on the apparent differences in cash flow amounts of the two plans?

Answer

The cash flows generated by the League plan would be insufficient to resolve the failing assets of the industry's problem institutions over the next five years. The FSLIC estimates that it will need $20 to $25 billion, and the League's plan provides only $13 billion. The Treasury/FHLBB plan will make over $25 billion available over the 5-year period.

I believe that it is critical to provide the FSLIC with the necessary amount of money over the next five years because the longer the resolution of failing thrifts is postponed, the greater will be the ultimate cost of solving the industry's problems. The FSLIC estimates that failing institutions are currently losing a total of $6 million per day because the FSLIC does not have the funds to merge them.

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Garn -- Gould

The U.S. League's cash flow table, which compares the cash flows to the FSLIC under the different proposals, is misleading. It subtracts the borrowing cost for the Treasury/FHLBB plan but ignores the borrowing cost for the League plan. At the end of 20 years, the industry will have to pay a borrowing cost of $22 billion, with the FHL Bank System assuming a large portion of the interest cost, but the table does not include this cost.

Question 6

In the event the Treasury proposal for FSLIC recapitalization becomes law, will it still be necessary to collect the special assessment now being levied on member-FSLIC institutions?

Answer

Treasury is committed to ending the special assessment of the thrift industry as soon as possible. In fact, the Treasury/FHLBB plan was designed to produce sufficient funds early in the recapitalization plan to make the phase-out of the special assessment possible. We have incorporated a five-year phase-out of the special assessment into our cash flow projections, and I believe that our plan will allow the special assessment to be ended.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

GEORGE D. GOULD

Question 1

The Baker plan to promote growth in debtor countries requires the extension of credit from U.S. commercial banks if it is to succeed. If banks are permitted to engage in security underwriting activities which create new profit centers for them, then won't they be most reluctant to lend the funds to debtor nations? Therefore, doesn't Secretary Baker's advocacy of an expansion of securities powers to banks undermine the Baker plan?

Answer

For years commercial banks have been authorized to underwrite and deal in the securities of the U.S. Government and the general obligation bonds of municipalities. We are proposing that, in addition, they be authorized to underwrite and deal in municipal revenue bonds, mortgage-backed securities and commercial paper. All the new and old securities activities would have to be conducted through the securities subsidiaries of the bank's holding company. This expansion of incremental underwriting activity could make a significant addition to bank holding company profits but would in no way substitute for or rival their income from commercial lending at home and abroad, even at the present time of slower world economic activity than we would like to see.

Moreover, underwriting does not require a large use of funds as does commercial lending. Underwritten securities are purchased from the issuer and resold within a short period of time. While a large volume of business requires capital, it does not require the amount of funds that would be needed to purchase the securities and hold them or to make loans to borrowers. As a result, the underwriting business will not be a major competitor for bank holding company funds.

Additional securities underwriting business should complement other bank activities including lending to foreign countries. It will give banks an additional source of income to diversify their earnings and make them more stable when one or more activity, such as lending to foreign governments, is less profitable.

Question 2

Considering the highly concentrated nature of the Japanese banking industry and the symbiotic relationship between the Japanese government, Japanese corporations and Japanese banks, isn't the real surprise that it has taken the Japanese so long to become 4 of the 5 largest banks in the world rather than the fact that they achieved this status? Has the size of these foreign institutions resulted in placing American institutions which compete in the international markets at a competitive disadvantage?

Answer

Certainly the Japanese government is very supportive of the country's business organizations. Nonetheless, Japanese banks have become world leaders in banking, in part, because they have had access to the largest market in the world for financial services, the United States. This has enabled them to provide truly global services to Japanese and foreign multi-national corporations. American banks, on the other hand, are limited in the number of activities they can perform in foreign countries, since in many countries they cannot operate retail branches or otherwise have ready access to local currency deposits. To offset this disadvantage American banks need greater resources and a wider range of services at home that they can offer U.S. multinational corporations, foreign governments, and other customers.

To assist American banks in this regard, the Administration has endorsed interstate banking which enables banks to increase their deposits and expand their capital to give them larger lending limits for dollar loans. In addition, the Administration's proposals to increase bank securities activities would diversify the services banks could offer to make them more valuable to their customers. The larger capacity for lending and broader product line would help American banks strengthen their domestic advantage to compete with foreign banks that can operate on the same terms in the United States and often more favorably at home than American banks.

Question 3

Secretary Baker has urged that our banking institutions be allowed to compete in a global market and they are doing so by opening foreign subsidiaries where they have free entry. Could you explain how the international competitiveness of our domestic commercial banks will be enhanced by permitting them to underwrite mortgage-backed securities, mutual funds, revenue bonds and commercial paper?

Answer

These new securities activities would enhance bank international competitiveness in several ways. First, the new activities would give banks an additional source of income, one that is fee based and not dependent on the spread between their cost of funds and lending rates. This diversity in source and form of income should strengthen bank earnings and make them more stable over the economic cycle. Greater earnings stability should enhance bank competitiveness at home and abroad. In addition, earnings create capital, and capital is, and will increasingly become, a very important competitive tool.

Secondly, the new securities activities would diversify the types of business that banks can perform for customers. While American banks can underwrite a wide variety of securities overseas, they can offer only limited underwriting services to customers domestically. In this regard they are less competitive than other domestic and foreign financial service organizations, especially securities firms, which are rapidly expanding their global operations.

Thirdly, by permitting banks to expand into new securities activities, it will make them more attractive to potential customers both in the U.S. and abroad since the securities business, and, indeed most financial services activities are built upon trust in and experience of the institution providing the service.

When banks have many sources of earnings and can offer a wide range of products and services to customers, they are less likely to suffer seriously from any economic or financial adversity in any one line of business. Hence, a better mix of earnings and broader range of services increases safety and soundness prospects for financial institutions. As a result, the expanded securities activities we are proposing would not only enhance the competitiveness of banks but would also increase their financial prowess to the advantage of the regulatory system and the financial system in general.

Question 4

Isn't the real problem with competitiveness the failure of banking institutions to offer credit at interest rates competitive with the rates borrowers must pay to the holders of their commercial paper?

Answer

Banks are unlikely to ever be able to offer rates on commercial loans as low as those on commercial paper. Banks must raise money from depositors to relend and must cover their operating costs and earn a profit on their capital from making loans. The need to earn a "spread", operating costs, capital costs plus profit, makes commercial loans more costly to borrowers than commercial paper.

In a commercial paper transaction a corporation issues its IOUs directly to the lender, an individual or other business. Such a lender, not a financial intermediary, generally is lending excess cash and not raising funds in the marketplace to relend. Consequently, such a lender does not have to earn a spread between its cost of funds and its loans. It can lend at market rates.

The commercial paper market is simply more efficient for raising money than borrowing from a commercial bank for the largest corporations with the best credit ratings who can borrow at the most favorable interest rates. Commercial paper is a permanent alternative to bank commercial loans, and banks must make up for this lost business by helping corporations find customers for their commercial paper and by underwriting it.

Question 5

Chairman Volcker has often warned this committee about the explosion of corporate debt in this country. Wouldn't this problem be exacerbated by allowing commercial banks the ability to underwrite corporate debt?

Answer

No. The amount of corporate debt is determined primarily by supply/demand factors influenced by business conditions, the cost of capital, tax incentives, etc., not the distribution system. Allowing banks to underwrite corporate debt would make the capital raising process more efficient and reduce costs to borrowers, but it would not induce significant additional borrowing.

Question 6

If a bank holding company is allowed to engage in securities underwriting and this is an approporate banking activity, and you believe that commerce and banking should remain separate, do you also feel that no commercial concern should be able to acquire a firm that engages in underwriting activity? If commercial entities are allowed to acquire securities firms, which you have characterized as an appropriate banking activity, then why shouldn't commercial firms be allowed to engage in other banking activities? How do you draw the line?

Answer

You ask why -- if commercial firms already can affiliate with securities firms and securities firms should be able to affiliate with banks -- commercial firms should not also be able to affiliate with banks. Commercial firms already are affiliated with depository institutions in many cases through such existing mechanisms as the unitary thrift holding company. I can find little wrong with such operations, so long as the depository institution component is properly regulated and supervised just as a free standing bank owned by individual merchants in a small town would be. I want to work with Congress to pass meaningful legislation to promote a freer, more open financial services marketplace that benefits consumers and industry alike.

Question 7

Under Secretary Gould, on page 12 of your testimony you state that the Treasury would support expanded products and services for banks through separately capitalized facilities. What specific safeguards would you suggest to insure that the same self-dealing and conflicts of interest that were revealed in the hearings culminating in the Glass-Steagall Act? For example, should a bank's securities subsidiary be permitted to underwrite or securitize the credit extended by the parent bank?

Answer

I believe restrictions of the type contained in proposed section 23B of the Federal Reserve Act (passed by the Senate in 1984 as part of S. 2851), together with existing law, adequately address the concerns underlying the Glass-Steagall Act.

As you know, there already are numerous laws that deal with problems the Glass-Steagall Act was intended to prevent. These include the federal securities laws which regulate securities markets and securities industry professionals, require substantial disclosure to investors, and prohibit fraud; the establishment of the SEC to administer these laws; antitrust laws and Bank Holding Company Act protections against undue concentration and unfair trade practices; common law and bank regulatory prohibitions against self-dealing; and a federal deposit insurance system designed to promote confidence in the banking system.

In addition, in 1982 the Garn-St Germain Act significantly revised section 23A of the Federal Reserve Act, which restricts transactions between federally insured banks (member and nonmember) and their affiliates. Section 23A is designed to prevent the misuse of bank resources stemming from non-arm's length transactions between commonly controlled companies. It limits a bank's transactions (i.e., extensions of credit and transactions having the effect of funding the affiliate) with any single affiliate to 10 percent of the bank's capital and surplus, and with all affiliates to 20 percent, and requires that all such transactions be fully secured. The Garn-St Germain Act made the section 23A limitations applicable to REITs and investment companies advised by the bank, both of which previously were excluded from coverage. The Act extended the 23A limitations to all assets purchased by a bank, except those specifically exempted by the Federal Reserve Board, and to any guarantee, acceptance, or letter of credit on behalf of an affiliate. Section 23A also was amended to prohibit a bank from purchasing "low-quality" assets from any affiliate. In addition, amended section 23A substantially liberalized the list of eligible collateral for transactions between a bank and its affiliates. Finally, all such transactions now must be on terms consistent with safe and sound banking practices.

In addition to existing restrictions, I believe Congress should add a new section 23B to further ensure that there will be no abuses of the type Congress contemplated in enacting the Glass-Steagall Act. New section 23B would provide that a member bank and its subsidiaries may engage in certain transactions with an affiliate only if the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with nonaffiliated companies. If there are no comparable transactions, the terms and conditions of the transaction must be the same as those that, in good faith, would be offered to or would apply to nonaffiliated companies.

Transactions subject to this limitation would be:

(1) any covered transaction, as defined in section 23A, with an affiliate;

(2) a sale of securities or other assets, including assets subject to an agreement to repurchase, to an affiliate;

(3) the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;

(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; or

(5) any transaction or series of transactions with a third party if (A) an affiliate has a financial interest in the third party, or (B) an affiliate is a participant in such transaction or series of transactions.

Section 23B also would prohibit a bank and its subsidiaries from purchasing as fiduciary any securities or other assets from an affiliate, unless such purchases were authorized by the instrument creating the relationship, by court order, or by the law of the jurisdiction under which the trust is administered. The section also would prohibit a bank and its subsidiaries, whether acting as principal or fiduciary, from knowingly either purchasing or acquiring, during the existence of any underwriting or selling syndicate, any obligation for which an affiliate or subsidiary of the member bank is a principal underwriter.

In general, I do not believe that a bank's securities affiliate should be prevented from underwriting or securitizing credit extended by the bank (or underwriting and dealing in securities issued by the bank) when there are prudential ways to regulate and supervise those transactions. However, we remain open on these issues and are willing to work with the Committee to resolve them.

Question 8

Many critics of the Glass-Steagall Act suggest that banks have been squeezed out of their traditional sources of revenue and therefore need to expand into the areas of security underwriting. This argument seems hollow in light of the Wall Street Journal article demonstrating the profitability of these institutions through their traditional lines of business. Incidentally, the most profitable banks are those that are most vociferously arguing for the expansion of bank powers. Would you comment on the internal inconsistency in this argument?

Answer

The large, money center banks have been among those most interested in expanded securities activities and these are relatively profitable institutions. Their government securities business has been an important contributor to their profits. It is unclear how much commercial lending has contributed to income in recent years. The Comptroller of the Currency recently announced that he intends to conduct a study of bank profitability to learn more about the sources of bank earnings.

In the last 10 years money center banks have grown and profited substantially from international business. However, over the next couple of years we will get a better sense of just how profitable much of the international business put on in the last few years really is. There is a considerable uncertainty at the moment about the returns on credits to many developing countries that are having difficulty paying interest and principal on their loans. These banks are concerned about the future profitability of their existing international business and they are concerned about how much the international lending market will grow in the future. In addition, they are experiencing loan securitization domestically which may diminish the amount of traditional lending business they retain on the books in the United States. It is these foreign and domestic developments that are motivating the banks' efforts to expand and diversify the products and services they can offer to industry and consumers.

Question 9

On page 15 of your testimony, you mention that "outdated and unfair restrictions on the U.S. banking industry are hindering its ability to compete in global markets." This statement conflicts with Chairman Volcker's statement at the January 21, 1987 hearing that U.S. banks are on the "cutting edge of foreign competition." Can you explain the difference in these two positions and to what specific "outdated and unfair restrictions" are you referring?

Answer

American banks have been among the most innovative and aggressive in expanding international business but they have also suffered from outdated and unfair restrictions in this connection. The absence of interstate banking in the United States has limited the relative size of our institutions and their ability to collect more stable retail deposits. It has also limited their ability to make larger lines of credit available to multinational corporations. Most foreign banks come from countries where nationwide banking has been the practice for many years.

In addition, many foreign banks have broader lines of business. Most European banks are permitted more extensive securities operations and Japanese banks have close affiliations with trading companies. The lack of a larger retail deposit base and less diversified earnings put American banks at a competitive disadvantage. We have had more major bank failures than any other developed country. The Administration has addressed these problems by endorsing the regional interstate banking compacts and favoring nationwide interstate banking. It supports also the liberalization of bank securities activities to broaden and diversify the sources of bank income and thereby strengthen the institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

GERALD J. LEVY

Question 1: The Treasury has argued that even if insolvent thrifts are closed after the FSLIC is recapitalized, the remainder of the industry will still be grossly undercapitalized and will be unable to raise needed capital by itself. The Treasury's solution is to liberalize the laws to allow commercial and industrial firms to own thrifts. Please comment on the Treasury's approach.

Response:

i) We believe that, given time, most institutions can continue to raise their capital levels internally and through accessing the capital markets which so many of our institutions have successfully done over the last several years. Institutions that cannot do so can be merged into stronger financial institutions. It is in order to preserve the charter value of such institutions that the League has supported your call for a closure of the nonbank bank loophole.

Indeed, it is in order to help assure a period of stable interest rates for institutions to rebuild their capital levels that the League has made the reduction of federal budget deficits a top priority policy item.

ii) While we have not seen any details on the liberalization the Treasury has in mind, the U.S. League support the ability of commercial and industrial firms to own thrifts and register as savings and loan holding companies. The fully-regulated unitary savings and loan company structure has been, and will continue, to be an important means of attracting outside capital to savings institutions.

Question 2: In your written statement, you contend that "although most savings institutions place holds on checks deposited by customers, the effect is of little consequence to most customers." I hear plenty of bank and thrift customers saying that check holds are a major inconvenience. What is your basis for saying that those holds are "of little consequence to most customers"?

Response: Deposit holds rarely affect the interest earned on funds a customer deposits to a NOW account or a savings account. Whether or not they place a hold on a deposited check, most savings institutions pay interest on such funds from the date they are deposited, or from the date provisional credit is received. Customers thus earn interest on such funds even though the savings institution may have to wait as much as a week or more to receive the proceeds of the check. It is reasonable to assume that many check hold complaints relate to ordinary, non-interest-bearing accounts used by customers for bill-paying purposes. As the Committee is aware, despite the much-heralded deposit deregulations, federally-chartered savings institutions and most state chartered thrifts are not authorized ordinary checking accounts for individuals. Thus savings institutions are less likely to receive check-hold complaints from their customers than might occur at commercial banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM GERALD J. LEVY

1. UnderSecretary Gould characterized as unrealistic the way the U.S. League has calculated the "net income" estimate of the industry for the years 1986-2007 and the calculation of the "shortfall made up by the business." Could you respond to UnderSecretary Gould's remarks?

__Response:__

The League's plan does not depend on projections of the net income of the industry. Presumably this question relates to the net income projections for the Federal Home Loan System. As outlined in the League's Task Force report, the 20% of net income set-aside from the Federal Home Loan Banks could completely cover the debt service, under the assumptions used, if that income grew by 9.5% per year. The League is not actually forecasting that the earnings of the System would grow by that amount since there is a provision in its plan whereby if the net income of the Bank System did not grow sufficiently for the 20% debt contribution to fully cover the debt service, the industry would make up the deficiency. However, it should be pointed out that between 1978 and 1986, the net income of the Federal Home Loan Banks grew at an average rate of almost 15% per year.

2. Would investors be more likely to buy the bonds issued by the financing corporation under the treasury plan or would they be more likely to buy the bonds issued under the U. S. League plan? Why?

__Response:__

Representatives from Wall Street, appearing __on behalf of the Treasury and the Bank Board__ before an informal session convened by the staff of the House Banking Committee, stated that both League's and the Treasury's programs were saleable to investors. They did suggest that the bonds in the League's program would probably carry a higher interest rate than those in the Treasury's proposal for three reasons:

a. The yield on the zero coupons issued under the League plan will be higher than on the "straight" debt securities issued under the Treasury plan. Zero coupons have a longer effective maturity, or duration, in technical terms, than equivalent maturity straight debt and will, therefore, carry a higher yield in an environment of an upward-sloping yield curve.

b. Under the Treasury/Bank Board proposal, investors are guaranteed the return of their principal because the funding corporation will purchase a sufficient amount of zero coupon bonds to defease the principal of the securities issued.

c. There is a rather thin and undeveloped market for zero coupon securities.

For these reasons, it was estimated that, at present, the straight debt of the Treasury/FHLBB plan would initially sell at a yield of perhaps 8-1/2% and that the zero coupons of the U.S. League plan would sell at around 9 1/2% to 9 3/4%, conceivably as high as 10%. The yield spread would thus be around 1-1/4 percent.

Looked at in this very narrow sense, the U.S. League does not argue about these estimates of the comparative costs of debt issuance under the two plans. But that does not end the discussion of the relative merits of the plans. There is far more involved than a simplistic yield comparison:

a. On a $5 billion bonding for the first two years, the added expense of a 1-1/4% yield differential would add up to $62.5 million per year. This additional cost must be looked at in the context of a situation where the business is currently paying over $1 billion per year in special insurance premiums and would likely have to continue to pay it if the Treasury/Bank Board plan is adopted.

b. Some of the yield spread between the zero coupons and the straight debt is argued to come from the greater security that investors perceive from the up-front dedication of existing FHLB System capital to guarantee the retirement of principal. However, this assurance is purchased at a cost -- the foregone earnings on the funds taken out of the Bank System. Ultimately the vast bulk of FHLB System earnings are returned to member institutions so that the lower interest expense on the bonds in the Treasury/Bank Board plan is accompanied by lower dividends to member institutions from the Federal Home Loan Banks.

   The Treasury estimates that $2.2 billion would be needed to defease the principal on $15 billion in borrowings. Using the same proportions, therefore, $733 million would be needed to guarantee the repayment of principal on the $5 billion in borrowings contemplated under the League's proposal. Currently, the Federal Home Loan Banks charge approximately 8-1/4% on long term advances. Thus, the foregone earnings on the $733 million would amount to $60 million per year -- approximately the same as the added cost of the zero-coupon bonds.

c. Most importantly, the League's proposal does not depend crucially on the bonds being issued in the form of zero coupon securities. The plan advocated by the League is an attempt to put a broad proposal in concrete form. All of the details need not be as outlined in the plan. If the zero-coupon aspect of the bonding program were to be a major drawback, the form of the bonds could be changed without doing violence to the concept of the plan.

   Thus, for instance, the funding corporation could issue regular coupon bonds under the League's proposal. The interest each year along with an additional amount to eventually retire the principal would be paid each year from a dedication of 20% of the Bank System's net income. To the extent that this dedication is insufficient to service the debt, the deficiency would be made up by a first call on the premium assessments on the industry.

   Two such possible structures are outlined in the attached tables. In both of these the funding corporation would issue regular coupon bonds (at an interest rate assumed at 8.5%, the rate at which the Wall Street representatives estimated that regular coupon securities could be issued). The two possible structures would be as follows:

   i) The interest would be paid each year along with an additional payment to eventually retire the principal which would be set aside in a sinking fund. The sinking fund payment for each particular year would be determined as that amount which, at the long term rates available at that particular time, would pay off 1/20th of the principal at the end of the 20th year of the program.

In 1987, all of the 20% of Bank System earnings would not be required to service the debt issued to date. The excess would be set aside in a temporary reserve fund to help service the debt in years 3 and 4.

Under the conservative assumptions used (monies in the sinking fund earn at a long term rate of only 5% and the Bank System's net income grow at only a 5% annual rate), the 20% of earnings from the Bank System would not be sufficient for debt service in the fourth through the fifteenth years. For those years, the deficiency would be made up through a diversion of a portion of the business' insurance premiums to the funding corporation. However, again under the assumptions used, this diversion would reach a maximum of only 19% of the regular premium.

ii) Essentially the same structure would be used except that the principal on the bonds would be defeased through tapping the Bank System's retained earnings for $710 million which would be used to purchase zero coupon securities to pay off the principal after 27 years. (Note that in the example given in the attached table, the Bank System's earnings are appropriately lowered to allow for the loss of earnings on this contribution). The $710 million needed is approximately one-third of the $2.2 billion that the Treasury/Bank Board plan envisages taking from the System's retained earnings to defease $15 billion in borrowing principal. Just as in the Treasury/Bank Board plan, this procedure would stretch the length of the program to allow sufficient time for the $710 million to grow to a sufficient amount to defease the $5 billion in principal.

The point to be emphasized here is that the borrowing approach of the League's program can be structured in various ways. The objective would be to consult with investment bankers to determine what the least costly approach would be. This development process need not delay the necessary FSLIC recapitalization legislation since all of the details need not be spelled out in the statute.

Indeed, it may very well be the case that these details should not be spelled out by statute since over the two year period of the program conditions in the market could change so that the optimal approach at the start may not remain the best. Perhaps it would be advisable to spell out in the statute only the broad parameters of how the borrowing is to be structured and to leave the details to the funding corporation authority.

3. One of the main criticisms of the Treasury recapitalization plan is that there is no end in sight to the special assessment that can be levied against FSLIC insured institutions.

   A) could this criticism be eliminated if there were a provision in the legislation which would specifically phase out the special assessment? Would you support legislation containing such a phase out?

Response:

In response to a question from the Federal Home Loan Bank Board, 14 investment banking firms responded in writing last year that the power of the Bank Board to levy special assessments on the industry was necessary for the saleability of the bonds and that it would be unwise for Congress to legislate its phaseout because that would make the bonds difficult to sell. The firms were unanimous in their support for the retention of the special assessment authority to support the borrowings under the Treasury plan and used terms such as "absolutely essential", "integral" and "crucial" in its regard. This is precisely one of the main reasons why the League has opposed the Treasury proposal and offered a more modest one in its place. The League would most definitely favor a legislated phaseout of the special assessment but it cannot realistically see that happening if the full-blown Treasury proposal is adopted because of the requirement to fund $1.2 billion in interest payments each year. The following table makes this case explicitly:

IMPACT OF TREASURY/BANK BOARD PLAN ON FSLIC INSURANCE PREMIUMS

YEAR	TOTAL DEPOSITS	REGULAR INSURANCE PREMIUM	SPECIAL INSURANCE ASSESSMENT	TOTAL INSURANCE PREMIUMS	INTEREST ON BORROWINGS	NET INSURANCE PREMIUMS
1987	$948,259	$790	$1,185	$1,976	$0	$1,976
1988	1,005,155	838	1,047	1,885	240	1,645
1989	1,065,464	888	888	1,776	480	1,296
1990	1,129,392	941	706	1,647	720	927
1991	1,197,155	998	499	1,496	960	536
1992	1,268,984	1,057	264	1,322	1,200	122
1993	1,345,124	1,121	0	1,121	1,200	(79)
1994	1,425,831	1,188	0	1,188	1,200	(12)
1995	1,511,381	1,259	0	1,259	1,200	59
1996	1,602,064	1,335	0	1,335	1,200	135
1997	1,698,187	1,415	0	1,415	1,200	215
1998	1,800,079	1,500	0	1,500	1,200	300
1999	1,908,083	1,590	0	1,590	1,200	390
2000	2,022,568	1,685	0	1,685	1,200	485
2001	2,143,923	1,787	0	1,787	1,200	587
2002	2,272,558	1,894	0	1,894	1,200	694
2003	2,408,911	2,007	0	2,007	1,200	807

If the six-year phasedown schedule were followed, the FSLIC would have negative net premiums in 1993 and 1994 and would have to dip into an $800 million interest reserve set-aside in the Treasury plan.
It would take sixteen years (till the year 2003) for the net premiums after interest payments to reach the same $800 million level as raised by the regular premium in 1987. Does anyone seriously believe that the FSLIC, insuring $2.5 trillion in deposits at that stage, would be allowed to operate with only that level of premium income?

B) some contend that the failure to provide for a phase out of the special assessment would result in a mass exodus of healthy FSLIC insured institutions to such an extent that restrictions would be required to prevent institutions from switching from FSLIC insured institutions to FDIC-insured institutions. How many institutions would actually be able to transfer to the FDIC in light of net worth requirements and other restrictions? Should we consider legislation to prevent such an exodus?

Response:

i) Bond investor confidence could be undermined if strong institutions, faced with the debt service on Treasury's $15 billion bond plan, leave the FSLIC. The assurance to investors in the bonds that they will be repaid in full in either program, comes from the FSLIC's ability to assess the industry.

If the Treasury program were adopted it would be important, therefore, to keep this "tax base" intact. However, the Treasury/Bank Board proposal is potentially so costly to the business that it has been suggested that it would be necessary to impose prohibitive exit fees on institutions that would otherwise consider it in their economic interest to flee the FSLIC insurance system. An exit fee of up to 1-1/2 percent of deposits has been suggested by the chairman of the Federal Home Loan Bank Board in recent testimony.

This brings up a twofold problem for savings institutions who need to raise much-needed capital. Either they face a future where an indefinite continuation of the special assessment appears likely or they will suffer an immediate forfeiture a significant portion of their current capital in order to escape that fate. Faced with either of these prospects, investors will be less inclined to invest in the capital offerings of savings institutions, thus raising the cost of such capital. Getting new capital into the industry is the best long-term cure for the problems facing the FSLIC. Since the Treasury program increases the difficulty of attracting capital, it is a short-sighted plan.

The League has not taken a position on the question of exit fees. However, we would find it very difficult to take a position in favor of such fees in the magnitude mentioned by the Bank Board since it would subject our member institutions to the unenviable choices mentioned above.

ii) We do not know precisely how many institutions could qualify for FDIC insurance. FDIC-insured institutions require primary capital of 5.5% of assets. At the end of September of last year, 1,668 FSLIC-insured institutions (52% of the total), holding 43% of the assets of the business had net worth, measured on a GAAP basis, in excess of 5% of assets -- an increase from 1,530 institutions with net worth over 5% in March 1986, only six months earlier. Even when measured on a tangible GAAP basis (i.e., after subtracting any goodwill on the balance sheet from capital), 1,270 institutions (39% of the total) were above the 5% level.

These institutions are turning in very healthy performances currently and are strengthening their capital position every day. Thus, we believe that there is a significant part of the industry that could qualify for transfer to the FDIC insurance system.

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C) couldn't tnis same criticism be levelled against the U. S. League plan since any shortfall in the cashflow needed to finance the debt incurred under this plan would be made up by FSLIC insured institutions? Wouldn't the institutions likely to exist under the Treasury plan be inclined to switch rather than pay?

Response:

The League's proposal has widespread support within the industry. It was developed by a blue-ribbon Task Force comprised of over forty representative leaders of the industry. It was adopted unanimously by both the League's board of directors (with representatives from every state) and by its Legislative Policy Committee. The state savings institution leagues in some of the largest states (including California, New York and Florida) have endorsed the U.S. League's approach. Thus, we believe the industry is solidly behind our approach.

The business has not objected to paying for the problems in its industry. Indeed, it has taken the possibly unique position of endorsing a proposal whereby the stronger members of the industry pay for the problems of the weaker, problems that those strong institutions had no hand in creating. All the industry asks is that a reasonable, measured approach be taken to solving those problems.

4. In his statement before the Committee George D. Gould had a number of criticisms of the u. S. League's plan to recapitalize the FSLIC. These included:

   a. A statement that the plan at best provides only $5 billion worth of assistance, and that amount being conditional upon raising it from FSLIC's cash position, not its reserves.

Response:

i) Tying the FSLIC funding proposal to the FSLIC's cash rather than reserve position is not an essential feature of the League's plan. However, the point should be made that the FSLIC should not be in the business of raising huge amounts of extra cash to fund accounting loss reserves, rather than actual losses from case resolutions.

ii) The U.S. League plan will provide the FSLIC with virtually the same $10 billion over the next two years as the Treasury/Bank Board plan. In testimony before the House Banking Committee, Treasury Undersecretary Gould admitted that, because of the FSLIC's "organizational constraints", $5 billion per year is the maximum that the "FSLIC can efficiently use to resolve problem cases".

iii) Being a long-term program projected into a very uncertain future, the one certainty about the Treasury/Bank Board plan is that the authorization will not be correct.

Optimistically, it may prove to be too much, in which case the markets will be faced with the prospect of absorbing $15 billion in borrowings whereas a lesser amount would have been sufficient.

Furthermore, the savings institution business is being asked to trust the administration authorities not to raise funds if they are not needed. Treasury Under Secretary Gould stated in his testimony before the Banking Committees of the Congress that:

> "(b)ecause the plan is flexible by design, FSLIC need not draw this full amount if the size of the problem turns out to be at the low end of the estimated range."

The industry believes that it should not be asked to accept on trust that an administrative agency will exercise such restraint in gathering funds to itself. This is particularly the case since the temptation to raise all the funds authorized may be irresistible because such funds could count as a reduction in federal budget deficits.

Instead of the optimistic outlook that the amount of funds provided may be more than sufficient to deal with the FSLIC's problems, many observers would assert that the $15 billion raised in borrowings in the Treasury/Bank Board plan will not be sufficient.

If there is a widespread feeling that the problems of the FSLIC are more than the resources provided under the Treasury proposal, then investors can take no comfort from the amount of the proposed funding. The most detrimental situation of all for public and investor confidence is for a plan to be adopted that purports to solve the problem definitively and that subsequently turns out to be inadequate.

The League's plan, on the other hand, is explicit about the uncertain nature of the problems and specifically asks the Congress to review the situation in two years. The U.S. League believes the best method of overseeing that the efficient use of the funds provided by the industry is to require that the Bank Board present its case to Congress for re-authorization for further borrowing in two years.

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B. A statement that it would be very difficult for the financing corporation to sell 20-year zero coupon bonds in the market due primarily to the vagueness of the repayment sources in the plan. He noted that, "the debt looks speculative at best."

Response:

i) As mentioned previously, the League's plan is an attempt to put a broad proposal in concrete form. All of the details need not be as outlined in the report. If the zero-coupon aspect of the bonding program were to be a major drawback, the form of the bonds could be changed without materially altering the essence of the plan. Indeed, the League is currently exploring the optimal structure for our proposal.

ii) The sources of repayment are not vague. Repayments come first from the dedication of 20% of the Federal Home Loan Bank System's net income. To the extent that such are not sufficient, the deficiency would be made up by an assessment on the industry. This would be specifically spelled out in the enabling legislation. Thus, the bonds in the League's program have two guarantors -- the business and the extremely strong Federal Home Loan Bank System -- whereas the $30 billion in interest in the Treasury proposal is backed by the business alone.

C. A statement that the bond interest rate selected by the League was unrealistically low at 8%.

Response:

The League's comparisons use the same 8% interest rate when looking at the costs of the Treasury program. Furthermore, the League in its deliberations looked at higher interest rates -- specifically at a 10% rate. Naturally, the costs are higher, the higher the interest rate. However, the Federal Home Loan Bank System also has a tendency to earn more at higher interest rates thus providing more funds from the 20% dedication of net income. And if the Bank System earnings do not increase sufficiently, the industry would be obligated to pick up the deficiency. Finally, as mentioned previously, the League is exploring the most efficient way to raise the funds. This might mean that a regular coupon borrowing approach would be used instead of using zero coupon securities.

D. A statement that the plan weakens the bank system by drawing from the FHL banks an annual $275 million or 20% of earnings whichever is larger, for 20 years.

Response:

Both the Treasury/FHLBB plan and the League plan involve extracting excess capital from the FHLB System. The Treasury plan envisages removing the present level of excess capital but permitting future additions to rebuild such excess capitalization. The League plan would leave the present amount of excess capital untouched but would capture future additions to excess capital and divert these amounts to the sinking fund to retire the securities issued by the financing fund.

The U.S. League's program does potentially rely more heavily on the Bank System than the Treasury/Bank Board proposal but that is only to the extent of the growth of the net income of the system. If the Bank System's earnings were not to grow at all, the League's approach would tap the Banks for $275 million per year for 20 years -- for a present value cost of approximately $2.7 billion, not markedly different from the $2.3 billion present value cost to the Bank System of the Treasury/Bank Board proposal.

If the Bank System's earnings grow, the call on its resources will be greater under the U.S. League program but it is, by definition, an affordable call on those resources since it would be a percentage of the Bank System's net income.

Thus, the League believes that its program will not strain the resources of the Bank System and should not make investors wary of the System's paper. In broad terms, the FHLB System has about $9.5 billion of paid-in capital, i.e., FHLB stock purchased by member institutions (and carried at par as an asset on savings institution balance sheets). Additionally, the Federal Home Loan Banks have about $2.3 billion in accumulated retained earnings. The vast bulk of these retained earnings is locked up in a "legal reserve" account to which, under the Federal Home Loan Bank Act, each year 20% of the net earnings of the system must be transferred. The initial idea of the 1932 act was to generate capital internally and eventually eliminate the need for paid-in stock but that goal has never been realistically attainable.

Even without the legal reserve and any future additions to that component, the capital to liability ratio of the FHLB System would remain at 8.33% (a 12 to 1 ratio is maintained between capital and consolidated obligations -- liabilities issuance - of the FHLB System). This is an extremely high capital ratio for an entity which takes no credit risk -- all loan advances to member institutions are fully collateralized with high quality paper pledged by the borrowing institution-- and no interest rate risk -- the funds raised by the FHLB System in the capital markets are exactly linked to the loans made to borrowers and FHLB System loan advances carry mark-to-market prepayment penalties to maintain that matched-book position.

Even without the past accumulation of, and future additions to, th legal reserve, the FHLB System will remain the premier agency credit.

Furthermore, the League feels that "diminishing returns" have set i for added capitalization of the FHLB System and that a partia transfer of the strength of that element of the integrated saving institution financing, regulatory and insurance structure makes considerable sense. The League feels that this would be a more efficient and productive allocation of capital within the system Furthermore, existing excess capital would be left with the FHLB System right now at the time of maximum uncertainty over the future of that entire integrated regulatory structure.

By contrast, the Treasury/FHLBB plan, which also implicitly admits that the FHLB System is overcapitalized and can withstand an immediate transfer of its excess capital (and some near term earnings otherwise transferable to the legal reserve) to the FSLIC, would simply allow that present, admitted imbalance to redevelop over time as the excess FHLB System capital would be rebuilt by the eventual resumption of transfers to the legal reserve.

The U.S. League plan envisages a more appropriate time profile of extraction of FHLB System excess capital.

As a final note, the League has been accused of advocating a program that, because of its greater potential reliance on the Bank System, would disadvantage smaller institutions since it has been contended that smaller institutions rely more heavily on the Bank System than do larger ones. In fact, while the Bank System is of crucial importance to all member institutions, an examination of the holdings of Bank System advances shows that larger institutions are even more reliant on Bank System funds than smaller ones.

We note also that small institutions without as free an access to non-deposit sources of funding are more dependent on FSLIC-insured deposits to fund their operations. The burden of the special assessment on those deposits is disproportionately large for small associations and it will help relieve that burden to shift more of the load to the FHLB System.

E. And a statement that the plan would raise only 1/3 of the money for over 1/2 of the cost of the treasury plan.

Response:

Precisely, the League's numbers show, in present value terms, that the its proposal raises 37.2% of that provided in the Treasury plan at 48.7% of the cost. However, the reason the two percentages are not the same involves a technical assumption that illustrates that the League was very conservative in its assumptions.

In order to be conservative, the League assumed that though the borrowings cost 8%, the money deposited in the sinking fund to repay such borrowings earned at only a 5% rate even though, since such funds would be earmarked to repay long-term debt, there is no reason why they could not be placed in longer-term investments higher on the yield curve.

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5. **Would you support the Treasury proposal if there was an annual cap on the bonding authority of the financing corporation which did not exceed $5.5 Billion?**

Response:

The League remains convinced that the situation is too uncertain to put a long-term program in place at this time and that it is appropriate that the Congress review the situation in two years. This is the most effective check we know of that ensures that the money raised will be used wisely. Furthermore, we do not believe that the savings institution business, which is providing the funds, should trust administrative authorities not to raise funds if they are not needed. Thus, we continue to oppose any long-term funding approach and to ask that the Congress adopt the more measured two-year plan instead.

FIRST ALTERNATIVE REGULAR COUPON BONDING STRUCTURE FOR U.S. LEAGUE FUNDING PLAN

ASSUMPTIONS:	
TOTAL BORROWINGS	$5,000 MILL.
AMOUNT ISSUED IN 1987	$1,250 MILL.
AMOUNT ISSUED IN 1988	$2,500 MILL.
AMOUNT ISSUED IN 1989	$1,250 MILL.
GROWTH RATE OF BANK SYSTEM EARNINGS	5.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.50%

YEAR	ANNUAL INTEREST EXPENSE	PAYMENT TO DEFEASE PRINCIPAL	TOTAL NEEDED ANNUAL PAYMENT	DEBT O/S	AMOUNT IN SINKING FUND	AMOUNT IN RESERVE FUND	BANK SYSTEM NET INCOME	BANK SYSTEM CONTRIB.	BANK SYSTEM CONTRIB. AS A % OF NET INCOME	SHORTFALL MADE UP BY THE BUSINESS	REGULAR INSURANCE PREMIUM	SHORTFALL AS A % OF REGULAR INSURANCE PREMIUM
1986	$0						$1,399					
1987	$40	$26	$66	$1,250	$26	$228	$1,469	$294	20.00%	$0	$790	0.00%
1988	$239	$79	$318	$3,750	$107	$229	$1,542	$308	20.00%	$0	$837	0.00%
1989	$412	$109	$521	$5,000	$221	$44	$1,620	$324	20.00%	$0	$888	0.00%
1990	$425	$115	$540	$5,000	$347	$0	$1,700	$340	20.00%	$154	$941	16.37%
1991	$425	$121	$546	$5,000	$485	$0	$1,786	$357	20.00%	$189	$997	18.90%
1992	$425	$127	$552	$5,000	$636	$0	$1,875	$375	20.00%	$177	$1,057	16.71%
1993	$425	$133	$558	$5,000	$801	$0	$1,969	$394	20.00%	$164	$1,121	14.66%
1994	$425	$140	$565	$5,000	$981	$0	$2,067	$413	20.00%	$151	$1,188	12.73%
1995	$425	$147	$572	$5,000	$1,177	$0	$2,170	$434	20.00%	$138	$1,259	10.93%
1996	$425	$154	$579	$5,000	$1,389	$0	$2,279	$456	20.00%	$123	$1,335	9.23%
1997	$425	$162	$587	$5,000	$1,620	$0	$2,393	$479	20.00%	$108	$1,415	7.64%
1998	$425	$170	$595	$5,000	$1,871	$0	$2,512	$502	20.00%	$92	$1,500	6.15%
1999	$425	$178	$603	$5,000	$2,143	$0	$2,638	$528	20.00%	$76	$1,590	4.76%
2000	$425	$187	$612	$5,000	$2,437	$0	$2,770	$554	20.00%	$58	$1,685	3.45%
2001	$425	$196	$621	$5,000	$2,756	$0	$2,908	$582	20.00%	$40	$1,786	2.23%
2002	$425	$206	$631	$5,000	$3,100	$0	$3,054	$611	20.00%	$21	$1,893	1.09%
2003	$425	$217	$642	$5,000	$3,471	$0	$3,207	$641	20.00%	$0	$2,007	0.02%
2004	$425	$227	$652	$5,000	$3,872	$0	$3,367	$652	19.38%	$0	$2,127	0.00%
2005	$425	$239	$664	$5,000	$4,305	$0	$3,535	$664	18.78%	$0	$2,255	0.00%
2006	$425	$176	$601	$3,750	$3,446	$0	$3,712	$601	16.18%	$0	$2,390	0.00%
2007	$319	$60	$378	$1,250	$1,178	$0	$3,898	$378	9.71%	$0	$2,534	0.00%
2008	$106	$13	$120	$0	($0)	$0	$4,092	$120	2.93%	$0	$2,686	0.00%
TOTAL								$9,887		$1,490		
PRESENT VALUE OF CONTRIBUTIONS								$4,064		$778		

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SECOND ALTERNATIVE REGULAR COUPON BONDING STRUCTURE FOR U.S. LEAGUE FUNDING PLAN

ASSUMPTIONS:

TOTAL BORROWINGS	$5,000 MILL.
AMOUNT ISSUED IN 1987	$1,250 MILL.
AMOUNT ISSUED IN 1988	$2,500 MILL.
AMOUNT ISSUED IN 1989	$1,250 MILL.
GROWTH RATE OF BANK SYSTEM EARNINGS	5.00%
EARNING RATE OF MONIES IN SINKING FUND	7.50%
LONG-TERM BORROWING RATE	8.50%

YEAR	ANNUAL INTEREST EXPENSE	PAYMENT TO DEFEASE PRINCIPAL	TOTAL NEEDED ANNUAL PAYMENT	DEBT O/S	AMOUNT IN SINKING FUND	AMOUNT IN RESERVE FUND	BANK SYSTEM NET INCOME	BANK SYSTEM CONTRIB.	BANK SYSTEM CONTRIB. AS A % OF NET INCOME	SHORTFALL MADE UP BY THE BUSINESS	REGULAR INSURANCE PREMIUM	SHORTFALL AS A % OF REGULAR INSURANCE PREMIUM
1986	$0						$1,399					
1987	$40	$710	$750	$1,250	$710	$242	$1,409	$282	20.00%	$0	$790	0.00%
1988	$239	$0	$239	$3,750	$764	$311	$1,479	$296	20.00%	$0	$837	0.00%
1989	$412	$0	$412	$5,000	$821	$225	$1,553	$311	20.00%	$0	$888	0.00%
1990	$425	$0	$425	$5,000	$883	$137	$1,631	$326	20.00%	$0	$941	0.00%
1991	$425	$0	$425	$5,000	$949	$62	$1,712	$342	20.00%	$0	$997	0.00%
1992	$425	$0	$425	$5,000	$1,020	$0	$1,798	$360	20.00%	$1	$1,057	0.06%
1993	$425	$0	$425	$5,000	$1,096	$0	$1,888	$378	20.00%	$47	$1,121	4.24%
1994	$425	$0	$425	$5,000	$1,179	$0	$1,982	$396	20.00%	$29	$1,188	2.41%
1995	$425	$0	$425	$5,000	$1,267	$0	$2,081	$416	20.00%	$9	$1,259	0.70%
1996	$425	$0	$425	$5,000	$1,362	$0	$2,185	$425	19.45%	$0	$1,335	0.00%
1997	$425	$0	$425	$5,000	$1,464	$0	$2,294	$425	18.52%	$0	$1,415	0.00%
1998	$425	$0	$425	$5,000	$1,574	$0	$2,409	$425	17.64%	$0	$1,500	0.00%
1999	$425	$0	$425	$5,000	$1,692	$0	$2,530	$425	16.80%	$0	$1,590	0.00%
2000	$425	$0	$425	$5,000	$1,819	$0	$2,656	$425	16.00%	$0	$1,685	0.00%
2001	$425	$0	$425	$5,000	$1,955	$0	$2,789	$425	15.24%	$0	$1,786	0.00%
2002	$425	$0	$425	$5,000	$2,102	$0	$2,928	$425	14.51%	$0	$1,893	0.00%
2003	$425	$0	$425	$5,000	$2,260	$0	$3,075	$425	13.82%	$0	$2,007	0.00%
2004	$425	$0	$425	$5,000	$2,429	$0	$3,228	$425	13.16%	$0	$2,127	0.00%
2005	$425	$0	$425	$5,000	$2,611	$0	$3,390	$425	12.54%	$0	$2,255	0.00%
2006	$425	$0	$425	$5,000	$2,807	$0	$3,559	$425	11.94%	$0	$2,390	0.00%
2007	$425	$0	$425	$5,000	$3,018	$0	$3,737	$425	11.37%	$0	$2,534	0.00%
2008	$425	$0	$425	$5,000	$3,244	$0	$3,924	$425	10.83%	$0	$2,686	0.00%
2009	$425	$0	$425	$5,000	$3,487	$0	$4,120	$425	10.31%	$0	$2,847	0.00%
2010	$425	$0	$425	$5,000	$3,749	$0	$4,326	$425	9.82%	$0	$3,018	0.00%
2011	$425	$0	$425	$5,000	$4,030	$0	$4,543	$425	9.36%	$0	$3,199	0.00%
2012	$425	$0	$425	$5,000	$4,332	$0	$4,770	$425	8.91%	$0	$3,391	0.00%
2013	$425	$0	$425	$3,750	$3,407	$0	$5,008	$425	8.49%	$0	$3,594	0.00%
2014	$319	$0	$319	$1,250	$1,163	$0	$5,259	$319	6.06%	$0	$3,810	0.00%
2015	$106	$0	$106	$0	($0)	$0	$5,522	$106	1.92%	$0	$4,038	0.00%
TOTAL								$11,181		$85		
PRESENT VALUE OF CONTRIBUTIONS								$4,591		$46		

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM IRV STOLBERG

Q.1. What is the position of the National Conference of State Legislatures on various proposals to close the so-called South Dakota loophole? If you had to live with a loophole closer on that issue, would you favor the provision that passed the Senate in 1984 or would you suggest some other resolution of that problem?

A. NCSL cannot support the "loophole closer" in the 1984 Senate bill or any other proposal that would prohibit states from granting greater powers to state-chartered institutions. But, speaking for myself and not on behalf of the conference, I support Senator Dodd's efforts to close the loophole.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM IRV STOLBERG

Q. 1. **You state in your testimony that your organization supports giving commercial banks the authority to underwrite municipal revenue bonds. Do you believe there is widespread support for this, even among smaller municipal governments? Testimony from other witnesses challenge this assertion.**

A. 1. NCSL supports giving commercial banks the authority to underwrite municipal revenue bonds (meaning both state and local revenue bonds). There is widespread support among state legislators for this proposal, since it could bring down the cost of borrowing by state governments. It would seem to make as much economic sense for smaller municipal governments as for states to support this proposal. And, I have no personal knowledge of opposition to the proposal from smaller municipal governments. Nonetheless, I would not in my capacity as President of NCSL presume to speak for cities and towns.

Q. 2. **How does your organization view the effort to close the so-called "state bank loophole" by applying the limitations of the Bank Holding Company Act to state-chartered subsidiaries of bank holding companies?**

A. 2. NCSL generally opposes efforts to prohibit states from granting greater powers to state-chartered institutions, but speaking for myself and not on behalf of the Conference, I support Senator Dodd's effort to close the loophole.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM WILLIAM S. EDGERLY

Q.1. In your written statement, you stress that to assure the safety and stability of the payment system there needs to be an outright prohibition of the use of a nonbank bank to process the payments of an affiliate except in the case of regulated bank and thrift holding companies.

This issue, as you know, has been raised before and is not well understood. Could you please give us some specific examples of the kinds of risks we face if we were to close the nonbank bank loophole without including a prohibition of the sort you recommend?

A.1. I. Loopholes Allowing Unregulated Holding Companies To Gain Access To The Payment System Through Non-Bank Banks and Thrifts Are Unlikely To Be Completely Closed

If the nonbank bank loophole were completely closed, and if the existing ownership of nonbank banks by unregulated firms was not grandfathered, so that no unregulated firms could use their own nonbank banks to process their payments, there would be no need for the prohibition we recommend to protect the payment system.

This approach would require that no "depository institution," as defined in Section 19(b) of the Federal Reserve Act, 12 U.S.C. §461(b), could be owned by an unregulated firm, because any "depository institution" has access to the Federal Reserve's payment system under Section 11A of the Federal Reserve Act, 12 U.S.C. §248a. To the extent that the definition of "bank" in the Bank Holding Company Act, 12 U.S.C. §1841(c), was narrower than the definition of "depository institution" in the Federal Reserve Act, an unregulated firm could own a "depository institution" which was not a "bank," and thus gain access to the payment system without being subject to regulation under the Bank Holding Company Act. A "depository institution" includes a bank which is eligible for federal deposit insurance, as well as one which is actually federally insured, 12 U.S.C. §461(b)(1)(A)(i). Thus the "bank" definition would have to include all banks eligible for insurance.

In addition, the definition of "depository institution" includes thrifts, some of which are organized in stock form and may be owned by holding companies. Thus, savings banks and savings and loan associations, which are insured by or eligible for insurance from FDIC or FSLIC, are "depository institutions," and have access to the payment system. 12 U.S.C. §461(b)(1)(A)(iii),(vi). Since the activities of unitary savings and loan holding companies are unlimited, and thus effectively unregulated, the activities of such holding companies would have to be limited, or effectively unregulated holding companies could continue to gain access to the payment system.

We believe it is highly unlikely that the bank definition would be broadened to include all banks that were depository institutions, that the activities of unitary savings and loan holding companies would be limited, and that this would be accomplished without grandfathering. If we are correct, then significant opportunities would continue to exist for unregulated companies to process payments through affiliated depository institutions, with significant risk to the payment system as a result.

II. Risks To The Payment System From Unregulated Holding Companies: Specific Examples

The payment system includes various participants: depository institutions, the Federal Reserve System, and transactors, those making and receiving payments through accounts held at depository institutions. It also includes various types of payments such as checks, automated clearing house (ACH) transactions, wire transfers, and book-entry securities transfers. The nature of these payments, and how they are processed through the Federal Reserve, is well set out in Appendix E to the Statement by Chairman Volcker before the Subcommitee on Commerce, Consumer & Monetary Affairs of the Committee on Government Operations of the United States House of Representatives (June 1986), which we have attached to this letter. The risks to participants in the payment system of allowing unregulated firms to process payments through their own depository institutions can be illustrated with regard to each of these forms of payment. In each of the examples, it is important to note that the source of risk to the participants in the payment system is the insolvency of the holding company.

Checks

Checks are the most common form of payment in this country, with the exception of cash. Forty billion checks are written annually, with an estimated value of $36 trillion. While the average value of a check is $900, 0.01 percent, or 40 million checks, are for a dollar value greater than $1 million, and many of these checks are written by large corporations.

1. Late Returns

An unregulated holding company (UHC) uses its account at its own depository institution (HCDI) to fund checks written to UHC's suppliers (SPs). UHC, which is experiencing severe cash flow problems, draws $75 million in checks to its SPs, against a zero balance in its HCDI account. UHC hopes to fund the payments from the proceeds of product sales, which it plans to wire into its HCDI account. The SPs deposit the checks for collection in their banks (DBs), and are given $75 million in immediate credit for the checks by the DBs. The DBs collect the checks either through the Federal Reserve (FR) or through a private correspondent (CB). The FR or the CB give the DBs $75 million in immediate credit. HCDI is presented with the checks by the FR or CB on Monday. Rather than dishonoring the checks, and alerting the SPs to UHC's severe financial difficulties, HCDI, at the instruction of UHC, holds the checks beyond the time at which the checks may be dishonored (midnight on Tuesday). As a result, UHC incurs an overdraft of $75 million on the books of HCDI, and HCDI incurs an overdraft on the books of FR or CB. SPs, who believe their checks have been paid, continue to furnish supplies to UHC. On Friday, UHC declares bankruptcy.

If the $75 million in checks have not been returned by HCDI, the FR or CB may experience a $75 million loss as a result of the HCDI overdraft. An attempt to collect on the $75 million will force HCDI into insolvency. In order to avoid this result, which will have adverse consequences for HCDI's federal insurer and uninsured creditors, which may include other banks, the Fed may be compelled to make a discount window loan to HCDI, that has the direct effect of financing UHC's business. A $75 million loss to CB may endanger the solvency of that bank, as well as the solvency of its uninsured depositors, which could include other banks. Finally, the SPs, while paid on the $75 million in checks, have been lulled into a false sense of security and have released further supplies to UHC, a large portion of which will now go unpaid as a result of UHC's bankruptcy.

Alternatively, if UHC orders HCDI to return the checks after the dishonor deadline--returns which the Fed or CB are likely to accept, even though late, since collecting banks do not generally check for late returns--HCDI will generate $75 million for the account of UHC, giving UHC a bit more time to generate cash for suppliers. In this event, the Fed or CB will be made whole, and the $75 million loss will fall on the DBs or the suppliers, depending on whether the DBs are able to chargeback the suppliers' accounts. While either the DBs or the suppliers will have a claim for payment against HCDI, due to the late returns, HCDI does not in fact have the funds to pay off the checks, and an attempt to collect on the unpaid checks will force HCDI into insolvency. Suppliers can be hit with a double impact--a loss on the dishonored checks and a loss on the supplies furnished to UHC on the assumption the checks had been paid.

2. Cash Concentration

UHC uses its bank to collect cash receipts from the proceeds of sales paid into DBs under a lock box arrangement

(LBA). Under the LBA, UHC has directed its customers to send checks in payment of goods sold by UHC to post office boxes in different areas of the country. The DBs pick up these checks on a daily basis and deposit them into UHC accounts at the DBs for immediate credit. The checks are then collected against the banks of the UHC customers. Also, on a daily basis, UHC deposits "depositary transfer checks" (DTCs) with HCDI, averaging $75 million, drawn on the anticipated cash balances at the DBs, created by the deposit of the lock box checks. HCDI gives UHC immediate credit for the DTCs, which HCDI then deposits with the Federal Reserve for collection, generating a balance of $75 million with the Fed. After the DTCs are deposited with the Fed, UHC uses the balance to send wire transfers for payments to suppliers.

On the day before UHC goes bankrupt, and in a situation where HCDI is knowledgable about UHC's financial difficulties, the cash concentration arrangement proceeds as normal, except that the DBs, which have heard rumors of UHC's situation, refuse to honor the DTCs because they are unsure that the lock box checks which they have deposited to UHC's accounts will be paid. They suspect that if UHC declares bankruptcy that many of UHC's customers will order their banks to dishonor these payments to UHC due to a concern that UHC will be unable to service the purchased merchandise. Upon the dishonor of the DTCs, HCDI's Fed account, which has already been debited for $75 million in connection with wire transfer payments to UHC's suppliers, is overdrawn.

The Fed then faces the choice of making a discount window loan to HCDI, which has the effect of funding UHC's business activity, or taking a $75 million loss and declaring HCDI insolvent. HCDI's insolvency could lead to losses to the federal insurer of HCDI, and to losses to the uninsured depositors of HCDI, which could include other banks. Here the Fed, as a participant in the payment system, and all those with relationships with HCDI, can be put at risk by HCDI's inability to exercise an independent credit judgment in its relationship with UHC. Based on a review of actual cases, it is clear that an independent bank faced with this situation would not allow its customer to fund wire transfers on the basis of provisional credits for the deposit of DTCs, and would rather insist that all UHC payments were made against finally collected funds.

ACH Payments

In 1985, approximately 283 million payments with a value of $1.5 trillion were made over the ACH by the private sector.

The average value of an ACH debit transaction is $8,000 and the average value of an ACH credit transaction is $1,400. While a small percentage of ACH payments is greater than $1 million, these transactions account for about 50 percent of the dollars transferred over the ACH system. Moreover, per item values of ACH transfers are somewhat misleading, since ACH items sent by an originating bank on a single tape aggregate a substantial number of individual payments.

1. ACH Debit Transaction

UHC uses ACH debit transfers as a means of collecting funds from its lock box accounts at various DBs. The example is essentially the same as the second check example above; the only difference being that the cash is collected by an ACH debit transaction rather than through the use of DTCs. As in the check example, the Fed may be forced to make a discount window loan to HCDI when the receiving banks refuse to honor the ACH debits originated by HCDI out of concern that the checks deposited under the LBA will not be made good by UHC's customers. Alternatively, the Fed may put HCDI into insolvency, with attendant losses to the federal insurer and uninsured depositors of HCDI.

2. ACH Credit Transaction

UHC uses ACH credit transfers to pay employees. The payroll is $75 million. UHC originates these credits through HCDI three days in advance of the "settlement date," the date on which employees are due to be paid. HCDI delivers these items to the receiving banks (RBs), the banks at which employees hold accounts, through the Federal Reserve. Settlement occurs by the Fed debiting the account of HCDI and crediting the accounts of the RBs. Under the rules of the ACH system, RBs must give credit to their customers (the employees) on the opening of business on the date they receive the ACH credits, but credits to the RBs are not final until posted by the Fed, which may be later in the day. If the bank originating the ACH credit, here HCDI, becomes insolvent on the settlement date, the Fed has the right to refuse to post credits to the reserve accounts of the RBs, and can return the credit items to the originating bank. In such event, the RBs will be left at risk.

Three days before its impending bankruptcy, UHC has put a $75 million payroll through HCDI as an ACH credit transfer. HCDI debits UHC's account on an overdraft basis upon UHC's representation that it expects to receive wire transfer payments from customers which will fund the payroll. HCDI clearly knows at that time that UHC is in financial difficulty. At the opening of business on the settlement date, the RBs credit UHC employees for $75 million. Later that day, due to the bankruptcy of UHC, HCDI is in danger of becoming insolvent. The Fed may now refuse to post the credits to the RBs, leaving them exposed to a $75 million loss. Alternatively, the Fed may post the credits, in part out of concern for the solvency of the RBs, and thus put itself in the position of holding a $75 million overdraft from HCDI. In this situation, the Fed may either make a discount window loan to HCDI to cover the overdraft, or allow HCDI to become insolvent with the attendant cost to HCDI's federal insurer and uninsured depositors.

If HCDI had exercised normal credit judgment, which would have been exercised by an independent bank making ACH credit transfers on UHC's behalf, HCDI would not have allowed UHC to make the transfers on an overdraft basis. Knowing that UHC was in financial difficulty, an independent bank would insist that ACH credits be funded in advance with finally collected funds.

Wire Transfers

1. FedWire

On an average day, depository institutions send over 180,000 FedWire funds transfers with a total value of $435 billion and an average size of $2.4 million. Risk to the payment system from FedWires can be illustrated by the following example.

UHC orders HCDI to make $75 million in wire transfers to two suppliers at another bank (RB). HCDI accepts the transfer instructions knowing that UHC is in financial difficulty. The wire transfers cause UHC to overdraft its HCDI account by $75 million, and HCDI, in turn, overdrafts its Fed account when it instructs the Fed to debit its account in connection with the transfers. The Fed credits the account of RB for $75 million. This credit is final when made and cannot be reversed by the Fed even if HCDI does not cover its overdraft (unlike an ACH credit). At the end of the day UHC declares itself bankrupt, and HCDI is unable to cover its $75 million overdraft with the Fed. The Fed may now either make a $75 million discount window loan to HCDI, thus funding the activities of UHC, or let HCDI become insolvent with the attendant costs to HCDI's federal insurer and uninsured depositors.

If UHC had held its account with an independent bank which knew UHC was in financial difficulty, that bank would not have allowed UHC to make $75 million in wire transfers on an overdraft basis. Instead, the independent bank would have insisted that wire transfers be made against finally collected funds. Such independent credit judgment would have protected the Fed, and the federal insurer and the uninsured depositors of the independent bank.

2. CHIPS

CHIPS is a private funds transfer network owned and operated by the New York Clearing House Association. More than 140 participants send wire transfers to each other during the day over this system. Daily payment flows on CHIPS average $450 billion, and peak volume days have entailed transactions of about $800 billion. The positions of participants are settled on a net basis at the end of the day. Net debtors (those whose payments to all other participants exceed payments from all other participants) settle their positions at the end of the day by means of FedWires to their accounts at the N.Y. Fed. After the Fed has received payments from the net debtors it credits the accounts of the net creditors.

If a net debtor were unable to settle, the settlement would be recalculated without including the transfers of that participant. This could put other participants, who had to meet new settlement positions, without the benefit of having received payments from the failed bank, in difficulty. This risk would be compounded by the fact that banks receiving payments for customers allow customers to draw on these funds during the day, before settlement occurs at the end of the day. While the receiving banks have the right to retrieve these funds from customers in the event that the bank sending the payments fails to settle, in practice it would prove very difficult. The failure of a bank to settle could result in a systemic chain reaction of failures by other network participants. In order to avoid this chain reaction effect, the Federal Reserve could be forced to make a discount window loan to the failed participant.

At present UHC could not use HCDI to make payments through CHIPS because CHIPS Rule 19 requires that a participant be a "commercial banking institution," i.e. a bank which both takes demand deposits and makes commercial loans. Since such an institution would be a "bank" within the meaning of the Bank Holding Company Act, its parent would be regulated as a bank holding company. Also, UHC could not gain access to

CHIPS by ownership of a thrift, since only "banking" institutions can be participants. The CHIPS rules thus serve to insulate the banking system from the risks of unregulated holding companies by denying participant status to depository institutions owned by such holding companies.

Book-Entry Government Securities Transfers

In book-entry government securities transfers over FedWire, transfers of securities are generally initiated by a depository institution representing a seller of securities. When these securities are received by the Fed on behalf of the depository institution representing the buyer, the receiving depository institution's accounts are automatically debited by the Federal Reserve for the amount of payment and credited with the securities, and the sending depository institution's accounts are credited with payment and debited for the securities. If the receiving bank has insufficient funds in its account, a daylight overdraft occurs.

Approximately $47 trillion in securities were transferred in 8 million book-entry transactions through the Federal Reserve in 1985. On average, over the two weeks ending May 23, 1986, 60 percent of the dollars transferred over the book-entry system were in transactions of $25 million or greater. Average daily overdrafts from book-entry transfers exceeded $40 billion in 1985.

If UHC were a dealer in government securities, it could take in securities during the day through HCDI. Since dealers do not normally fund incoming securities until the afternoon, HCDI would incur significant daylight overdrafts until that time. If UHC failed, HCDI would be unable to cover its overdraft with the Fed. The Fed would then have to decide whether to make a discount window loan to HCDI, and thereby effectively finance UHC's business, or whether to let HCDI and UHC fail. In the event the Fed were to let HCDI fail, the Fed's overdraft losses might be partially offset by the value of UHC's securities, which the Fed might be able to realize on as security for its overdraft loan, but the value of the securities could be less than the amount of HCDI's overdraft position, due to changes in interest rates or the fact that customers of UHC might already have paid UHC for securities delivered through HCDI and assert their own claims to these securities. The Fed would also be concerned with the effect on the liquidity of the government securities market if it permitted a dealer to fail.

The Fed relies on the receiving depository institution to police the credit risk of the dealer. Where UHC owns the depository institution, this control may be weak. In addition, since UHC is unregulated, UHC may be able to engage in a wide range of unsupervised activities.

Three key points emerge out of these examples:

1. The risks to the payment system from unregulated holding companies principally arise when the holding company is experiencing severe financial difficulties. In such circumstances the holding company may seek to stave off bankruptcy by obtaining credit from its depository institution, credit which would not be extended by an independent provider.

2. Other participants in the payment system can be put at risk due to the lack of independent credit judgment exercised by depository institutions owned by unregulated holding companies. These participants include other depository institutions and their customers, and the Federal Reserve. In addition, the federal insurer and uninsured depositors of the depository institution owned by the unregulated holding company can also be put at risk.

3. The Federal Reserve may be forced to rescue the depository institution owned by an unregulated holding company by making a discount window loan to the depository. While such loan will protect other participants against loss, it puts the Fed into the position of financing the activities of unregulated holding companies--it is these activities which have produced the overdraft position with the depository. This alternative may not be available if the depository does not have sufficient security to back up the discount window loan, since discount window loans are invariably made on a secured basis. If sufficient security does exist, less assets will be available to the federal insurer and uninsured depositors in the event that the depository is subsequently liquidated.

III. Risk To The Payment System Can Only Be Controlled By Prohibiting Unregulated Holding Companies From Processing Payments Through Their Affiliates

We believe that the combination of the lack of regulation of a holding company and the lack of independent credit judgment of the depository institution can only be controlled by preventing the depository from processing payments for its unregulated holding company.

We do not believe that risks to the payment system can be controlled by extending 23A of the Federal Reserve Act.[1] Section 23A operates ex-post, in the sense that violations are policed through the examination process and penalized by a modest fine. Holding companies in extreme financial difficulties will have strong incentives to exceed 23A credit limits during a day in the hope that later incoming payments will cover and reduce the credit exposure of their depository institutions. By the time a violation is detected, it will be too late. The payment system will already have been put at risk.

Nor do we believe that this problem can be solved by prohibiting depository institutions owned by unregulated holding companies from incurring daylight overdrafts on the FedWire system in connection with payments made on behalf of the holding company. As our examples demonstrate, risk to the payment system can arise from check, ACH debit and credit transfers, and book-entry securities transfers, as well as FedWire transfers. While the Federal Reserve Banks are scheduled to have a real time monitoring system to monitor, and conceivably limit, daylight overdrafts on FedWire, this monitoring system will not be able to monitor on a real time basis the daylight overdraft position of a depository institution across all payment systems and with regard to all forms of payment.

Even with regard to FedWire, transfers can be "funded" through credits generated with check deposits or ACH debits. These payments may be dishonored by the banks on which they are drawn, thus presenting the Fed with a de facto overdraft. This possibility was discussed in our examples. Further, the Fed would be unable to know whether a depository institution overdraft was generated by a payment on behalf of the holding company, or a payment on behalf of an independent customer. A prohibition on all daylight overdrafts by a depository institution owned by an unregulated holding company would go too far, depriving the institution of necessary flexibility to service the needs of customers where it does exercise independent credit judgment.

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[1] Section 23A, which limits loans to a single affiliate to 10% of capital, and loans to all affiliates to 20% of capital, does not currently cover daylight overdrafts because they are not considered to be loans. Further, section 23A does not apply to provision of immediate credit for checks or to overdrafts secured by government securities.

On the book-entry system, the seller of securities "drives" the overdraft level of the buyer's receiving bank. If the Fed were to refuse a delivery, due to the overdraft exposure of the receiving bank, significant disruptions could occur in the government securities market.

IV. Our Proposal Can Facilitate Deregulation

As we stated in our testimony, we believe a comprehensive approach is needed to foster increased competition in the financial services sector, and that the concept of a financial services holding company offers promise in this regard. Under this concept, a full range of financial services could be provided by the financial services holding company with the depository institutions that were part of the holding company being subject to current regulation.

We believe the financial services holding company concept could be structured to protect the integrity of the payment system, thus meeting the public policy concern for safety and soundness which has had the effect of blocking progress toward increased competition. Any measures adopted to protect the payments system could be applied to all financial services holding companies offering a wide range of services. Absent significant deregulation, current limitations on activities of bank holding companies and multiple savings and loan holding companies serve to protect the payment system without the need to add other measures of protection. Such measures are, however, needed in the case of holding companies owning non-bank banks or unitary savings and loan holding companies, which have no limits on holding company activities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM WILLIAM S. EDGERLY

Q. 1. You argue against allowing a bank to offer a checking account to an affiliate engaged in an activity not permissible for bank holding companies in general. Why not just prohibit all such account relationships between banks and their holding company affiliates?

A.1. **Bank holding companies have stringent controls on their permissible activities. These controls serve to limit the risks of such holding companies. Controls on these risks make it unlikely that a bank holding company will fail due to the riskiness of its holding company activities. Indeed, there are very few cases of bank holding companies failing as a result of the riskiness of their holding company activities. In addition, other forms of holding company regulation, such as capital and reporting requirements, and examination, contribute to reducing the risk of bank holding company failure. Reporting and examination, in particular, allow regulators to have advance warning of holding company difficulties which would permit taking measures to protect the payment system.**

Q. 2. Your concern over risk to the payments system arises from the danger that a bank will allow an affiliate to overdraft its account. Why not prohibit all such overdrafts or limit the overdrafts for a single customer to the bank's legal lending limit?

A.2. **As discussed in Part III to our answer to Question 1, we do not believe a lending limit approach, even including a zero lending limit, which is enforced after the fact, is sufficient to protect the payment system in those situations where protection is needed, i.e. where the unregulated holding company is in severe financial difficulties and seeks to make payments on an overdraft basis during a day, with expectation of cover later in the day, to stave off bankruptcy.**

Q. 3. Isn't the real danger of daylight overdrafts that they are not classified as loans for lending limit purposes? Please comment.

A.3. As stated in our answers above, a lending limit approach to the daylight overdrafts of unregulated holding companies will not be sufficient to protect the payment system against risk.

It would be undesirable to classify daylight overdrafts as loans, in general, because this would make it impossible for the payment system to operate. Daylight overdrafts for certain bank customers can often exceed 20% of a bank's capital. As long as the bank carefully monitors this credit risk, and exercises independent credit judgment, daylight overdrafts do not pose a general risk to the payment system. We believe that control of the level of daylight overdrafts is best addressed by current Fed policies, limiting total daylight overdrafts to a multiple of bank capital.

The fundamental argument we are making is that when a holding company is about to go bankrupt, normal independent banking relationships immediately produce defensive measures to seal off the payments system from risk. When the music stops, the participants move swiftly to protect their own interests. But when two of the players are related, the subsidiary will yield to the parent. In extremis, the parent will resort to extreme measures, and only the prohibition we have proposed will be effective.

We wish to emphasize that the prohibition, which sounds repressive simply because it is a prohibition, is actually a key potential step toward deregulation. It solves the dilemma of how to protect the regulated payments system while opening financial services to broad competition. In principle, this key device could permit wholly unregulated companies to own depository institutions for the reason that it offers effective protection, whereas no limitation approach does so.

Yours sincerely,

WS Edgerly

William S. Edgerly

Payment System Risk

This appendix will discuss the mechanics of the operation of the payments system and the risks that arise from depository institutions' use of the payments system. It will also address the special risks that arise due to depository institutions' processing of payments on behalf of their affiliates and the inadequacy of current controls in dealing with these risks. Finally, it will discuss how depository institutions' use of Federal Reserve payments services can, in effect, provide nondepository institution affiliates of the depository institutions with access to the discount window.

Depository institutions using Federal Reserve payment services create certain risks to the Federal Reserve and to other users of Federal Reserve payments services because of the potential for a failure of an institution before its payments are settled. Some of these risks arise because payments transactions may result in final and irrevocable debits to depository institutions' accounts either before the Federal Reserve can determine whether the institution whose account is to be debited has sufficient funds in its account to cover the debit or the institution can post adequate collateral at the discount window to cover any deficiency in the account.

This type of risk is most acute in the case of Fedwire funds transfers where large volumes of high dollar transactions are initiated by depository institutions with on-line computer or terminal links to the Reserve Banks. These transactions are final and irrevocable when made. Similarly, book-entry government securities transfers against payment involve a large volume of high dollar on-line funds and securities transfers. Although book-entry government securities transfers are technically reversible, they may not be reversible in practice in the event of a bank failure because of the inter-relationships of these transactions in the government securities market. Other types of transactions such as payments by check and automated clearing house also pose risks although generally these risks are currently less significant, either because the dollar volume is currently low (ACH) or because the transactions are reversible (checks).

In addition to risks arising from individual transactions, significant systemic risks arise from net settlements, particularly those involving private large dollar wire systems where transactions are settled after they occur. These settlements raise the specter of a failure to settle requiring the reversal of numerous payments and thereby affecting a large number of transactions and potentially the solvency of other institutions.

The Federal Reserve must balance risks to the Federal Reserve against its responsibility to insure orderly markets and the smooth and safe flow of funds through the payments system. For example, although the Federal Reserve could seek to avoid risks by refusing to process certain payments, if such a refusal is apparent to the markets it could suggest that the Federal Reserve will no longer extend credit to the institution. Such a market perception could trigger a loss in confidence in the institution. A refusal to process payments for an institution could also trigger problems in other depository institutions in the case of net settlements, particularly settlements for large dollar transfer systems. In order to avoid these problems, the Federal Reserve may wish to process payments resulting in overdrafts but with the expectation that they will be covered at the end of the day by adequately secured discount window loans. In order to fully appreciate these risks, it is necessary to examine the mechanics of the individual payment systems.

Funds Transfer

In processing funds transfers on Fedwire, Federal Reserve Banks transfer funds on the order of the transferor depository institution from its account at a Federal Reserve Bank to the account of the transferee depository institution at a Federal Reserve Bank. Under Board regulations, the payment is final when the funds are transferred to the account of the transferee depository institution or when a Reserve Bank advises the transferee depository institution of the credit to its account. Funds transfers are generally large dollar transfers and have the highest potential risk. On an average day, depository institutions send 181,000 Fedwire funds transfers with a total value of $435 billion and an average size of $2.4 million. Ninety-nine percent of these transactions are on-line, *i.e.*, are initiated at terminals or computers at depository institutions linked to Federal Reserve Bank computers.

This paper was prepared by Oliver I. Ireland, Associate General Counsel for Monetary and Reserve Bank Affairs in the Federal Reserve Board's Legal Division.

The institution sending a funds transfer on behalf of its customer is at risk if the customer does not have collected funds in its account to cover the transfer at the time the transfer is made. The sending institution is committed on a Fedwire funds transfer when it is sent; the institution does not have a right to retract the transaction if the customer is unable to cover the transfer by the end of day.

On a Fedwire funds transfer there is a risk to the Federal Reserve that the sending bank will be unable to cover the transfer in its reserve or clearing account at the end of the day. During the day, an institution could overdraft its account by millions, or even billions, of dollars. Fedwire funds transfer overdrafts exceed $40 billion per day. The sender net debit caps established by the Board as part of its Policy Statement Regarding Reduction of Risks on Large-Dollar Transfer Systems are designed to address this risk. A depository institution's board of directors must review the institution's ability to control, monitor and evaluate its daylight overdraft exposure and evaluate the institution's creditworthiness before the institution may incur daylight overdrafts on Fedwire. The Federal Reserve monitors the depository institutions' position *ex post* and counsels those that exceed their cap. Current capabilities do not permit real time monitoring of all institutions' accounts. Consequently, generally only financially troubled institutions are monitored on a real time basis so that overdrafts can be prevented before they occur. The Federal Reserve controls its risk with respect to other institutions by keeping track of their overall condition.

There is no risk to receiving institutions on Fedwire funds transfers since the Federal Reserve provides immediate finality for these transfers.

A diagram of a funds transfer is set forth in Attachment A.

Book-Entry Government Securities Transfers

In book-entry government securities transfers over Fedwire, transfers of securities are generally initiated by a depository institution representing a seller of securities. The securities are transferred from the transferor-seller depository institution to the account of the transferee depository institution acting on behalf of the buyer. The transferee depository institution's funds account is debited in the amount of the sale and the transferor institution's funds account is credited. If the transferee has insufficient funds in its account, a daylight overdraft occurs. A transferee depository institution may reverse erroneous transfers.

Approximately $47 trillion in securities were transferred in eight million book-entry transactions through the Federal Reserve in 1985. Daily overdrafts from book-entry transfers also exceed $40 billion.

There is risk to the Federal Reserve in book-entry security transfers that the transferee depository institution does not have sufficient funds in its reserve account to cover the amount of securities being purchased, and will be unable to cover the amount of the transfer in its reserve account by the end of the day. To a great extent, the Federal Reserve relies on the institution receiving the transfer to police its customers' activity. While the Federal Reserve could attempt to take a security interest in these securities, it might not be able to obtain a perfected security interest because of conflicting interests of customers of the transferee depository institution who have paid that institution for the purchased securities. Assuming that the Federal Reserve could perfect a security interest in the securities, it still would be exposed to a market risk that the selling price of the securities would be less than the "purchase" price.

For example, when the Bank of New York had computer problems in November of 1985, the Federal Reserve was able to make a loan of $22.6 billion to that bank to carry it through until the computer problem was repaired. Although at the time that the loan was made, the Federal Reserve Bank of New York was not able to determine the proportion of the securities in which it could obtain a perfected security interest, it was able to secure the loan with $13 billion of other assets as well as the purchased securities that had created the overdraft. Such "other assets" may not be available in the case of an institution created solely to obtain access to the book-entry system for an affiliate.

The transferee depository institution would be exposed to similar risks if its customer purchasing the securities cannot cover the amount of the transaction. First, the security interest in the securities may not be perfected, and second, if the interest is perfected, the securities may be sold at a price less than the transfer amount.

The Board did not include book-entry overdrafts in the risk reduction program that became effective in March of this year because of concerns about potential impacts on the government securities market. The Board expects to consider new proposals to bring book-entry government securities overdrafts within the ambit of this policy this summer. A diagram of a book-entry securities transfer is set forth in Attachment B.

Automated Clearing House (ACH) Transactions

ACH transactions include both credit and debit transactions. In credit transactions, on the order of an originating depository institution, funds are transferred from the originating depository institution's account to the account of a receiving depository institution. These transfers are processed in batches and the payment information is distributed prior to a settlement date. ACH credit transfers are generally treated as final at the opening of business on the settlement date; however, a Reserve Bank may be able to reverse such transfers up until the time that they are posted on the settlement date. ACH debit transfers involve debits to the receiving depository institution's account that are initiated by the originating depository institution. The receiving depository institution has until midnight of the banking day following the settlement day to reject any such debits.

ACH transactions account for only a very small fraction of the total dollar value of interbank funds transfers. The ACH is primarily a small dollar payments mechanism although, increasingly, large dollar payments are made through it, and the aggregate amount of a credit or debit ACH file originated by an institution's corporate customer can be quite significant. The Board is concerned about the increase in large dollar payments, particularly debits, over the ACH and is evaluating the increased risk implications of these transactions. In 1985, the Federal Reserve processed 283 million commercial ACH transactions valued at $1.8 trillion.

The risks to the depository institutions initiating ACH credit transactions are conceptually similar to those for Fedwire funds transfers. Although the dollar risk on ACH is typically lower than in Fedwire funds transfers, the temporal risk is greater. ACH credit payments are submitted and processed one or two days prior to settlement, and the exposure to the originating institution extends from this time until the account of the originating customer is funded to cover the transfers.

The Federal Reserve's risk from ACH credit payments begins on the opening of business on settlement day, and stems from the possibility that the sending bank may be unable to cover the transfers in its reserve account at the end of the day.

The receiver of ACH credit transfers processed by the Federal Reserve is at risk if the originator of the transfers fails on the settlement day and the Federal Reserve is unable to debit the originating institution's account for the amount of the transfers. In this situation, the Federal Reserve reserves the right to reverse the credit entries, debiting the receiving institution's account, until the end of the settlement day. The National Automated Clearing House Association guidelines strongly urge institutions to make credit entries available to depositors at the opening of business on settlement date. Thus, the receiving institution is at risk to the extent that it is unable to recover the funds from the depositors receiving the credits. As a practical matter, it is unlikely that the Federal Reserve would reverse ACH credit entries on the settlement day.

Risks to an institution originating ACH debits arise when it makes funds available to the payee before it is assured that the debit transfers will not be returned. The likelihood of a loss to the Federal Reserve on debit transfers is relatively small. When the Federal Reserve delivers ACH debits to the receiving institution, it debits the reserve or clearing account of the receiving institution, and credits the account of the originating institution. If the receiving institution returns some of the debit items, the Federal Reserve would credit the receiving institution for the amount of the returned items, and debit the account of the institution that originated the items. If the return items were destined to an institution that had failed subsequent to its origination of the debit transfers, the Federal Reserve would be at risk for the amount of the return items destined to the failed institution.

There is no appreciable risk to the institution receiving ACH debit items. The receiving institution has until midnight of the next banking day to return an ACH debit. Thus, its only risk lies in failing to return on a timely basis an ACH debit that cannot be posted.

Diagrams of ACH credit and debit transactions are set forth in Attachment C.

Checks

Checks are the most common form of payment in this country, with the exception of cash. Forty billion checks are written annually, with an estimated value of $36 trillion dollars. The Federal Reserve processed approximately 16 billion checks in 1985.

The depository institution receiving a check is at risk if it makes funds available to its depositor before sufficient time has elapsed to be relatively sure that the checks deposited will not be returned. This risk could be significant in the case of large dollar checks used to transfer corporate account balances between depository institutions for cash management purposes. The risk to the Federal Reserve arises where it is holding return items destined to a payor institution that has failed. The Federal Reserve would have a claim on the assets of the failed institution and could pursue the drawer of the check. However, in certain cases, such as where a depository institution processes a large dollar volume of checks deposited by a customer that has also failed and the failure of the customer has caused the drawers of the checks to stop payment on them, these risks may be substantial and such remedies may not be available. Generally the risks to the payor institution relate primarily to its failure to properly dishonor or pay an item.

A diagram of a check collection transaction is set forth in Attachment D.

Net Settlements

The Federal Reserve is also at risk on private funds transfer networks or other private payments systems for which it settles. Further, these systems generate systemic risks for their participants. These systems range from large dollar wire transfer systems such as CHIPS to local check clearing house exchanges. In such systems, payments messages or checks are transferred between institutions during the day and the Federal Reserve settles these payments at the end of the day with a single net entry to each institution's account. If one of the participants on a private payments system were unable to settle its net debit position at the end of day, the settlement would be recast without the transfers of that participant. This may worsen the financial position of other participants. An institution in a net credit position before the settlement was recast could find itself in a net debit position. On a large dollar wire system, the debit position could be far in excess of its capital in the recomputed settlement, triggering the institution's inability to settle. Thus, a failure to settle by one institution could result in a systemic chain reaction of failures by other network participants. The Federal Reserve could be forced to "rescue" the settlement through a discount window loan to reduce the systemic risk that the failure of one institution to settle would jeopardize the financial positions of other network participants. Daily CHIPS overdrafts of approximately $35 to $45 billion reflect the extent of this risk.

Finally, there is risk to the receiver of a funds transfer that is sent over a private wire network. Funds sent on a private wire network do not become final until the end of the day. If a sending bank were unable to settle, the receiving bank is at risk if funds sent by the failed bank are withdrawn by the payee and not recovered. To reduce and control the risk to receiving institutions, the Board has called on participants in private networks to establish bilateral credit limits, to limit the potential exposure a receiving institution has against each sending institution, and network sender net debit caps applicable to each network in order to limit the maximum overdrafts on such systems by individual institutions.

Relations with Affiliates

Payment system risks may be increased by depository institutions dealings with their affiliates. First, it is unlikely that a depository institution will make an independent credit judgment concerning overdrafts initiated by their affiliates as they do on their unaffiliated commercial customers. In the case of payments services provided by depository institutions for their unaffiliated customers, institutions generally review the credit risk associated with providing these services and generally monitor at least some of their accounts. A review of institutions' practices indicates a variety of approaches to monitoring their own customers, ranging from monitoring all corporate customers, monitoring on-line customers, monitoring large transactions or monitoring customers with deteriorating credit quality. The Board's daylight overdraft policy requires depository institutions to be in a position to monitor and control their customers' overdraft positions. The Reserve Bank processing the payment may, in turn, make an evaluation of the institution making the payment. In the case of troubled institutions, Reserve Banks may make individual decisions on a case-by-case basis as to whether to process payments for such institutions. These decisions are based on the balance in the institution's account, the availability of collateral to cover any overdrafts, supervisory materials, including examination materials on the institution and its affiliates, as well as additional market factors bearing on any potential decision not to process a particular payment.

There are practical reasons to conclude that a depository institution will not apply such controls to their affiliates or will disregard them when processing payments on behalf of its affiliate. There is no reason to believe that depository institutions processing payments for their affiliates are any less subject to undue influence by the affiliate in processing such payments than they are in extensions of credit and other transactions that Congress has specifically limited under section 23A of the Federal Reserve Act and other legislation.

Second, the affiliate may take advantage of its relationship with the depository institution in order to obtain credit from the institution for itself or its customers contrary to safe and sound lending policies. Such abuses are particularly likely in times of financial stress on the affiliate when an affiliate may force credit extensions by overdrafting the depository institution's account. These abuses may threaten the safety and soundness of the depository institution and may precipitate its failure.

Third, risks to depository institutions and, through them, to the payments system are increased by the Federal Reserve's lack of familiarity with some depository institution affiliates. Where depository institutions are affiliated with companies that are not subject to the same level of scrutiny as bank holding companies, the company may fail with little prior notice to the Federal Reserve. The company's failure may, in turn, precipitate the failure of the depository institution and attendant effects on the payments system. The lack of prior notice makes it more difficult for the Federal Reserve to arrange to monitor the institution's account on a real time basis or to evaluate collateral offered at the discount window in order to obtain adequate funds to cover the institution's payments until it can be closed or sold in an orderly fashion.

Inadequacy of Current Controls

Current statutes and procedures do not adequately address the risks arising from relations with affiliates. Section 23A of the Federal Reserve Act, which limits transactions between insured banks and their affiliates, and similar provisions applicable to federally insured thrift institutions, have not been interpreted to apply to daylight overdrafts. Further, section 23A does not apply to provision of immediate credit for checks in the process of collection or extension of credit to the extent that they are secured by government securities as may be the case in book-entry securities overdrafts by an affiliate. Further, section 23A is only enforced on an *ex post* basis and cannot prevent transactions, such as overdrafts, that threaten the safety and soundness of an institution before they happen even if it were interpreted to apply to such overdrafts.

Similarly, the current daylight overdraft risk reduction program, which is based on caps enforced through *ex post* monitoring, does not address the problem of overdrafts occurring in times of financial stress on the affiliate. At such times, the affiliate may prevail on the depository institution to make transfers in excess of its caps, which the affiliate is unable to cover. It is such transfers that are the essence of the risks presented by the institution's use of Federal Reserve services and it is such transfers that *ex post* monitoring is powerless to control.

Real time monitoring of a depository institution's accounts and rejection or delay of transactions that would create overdrafts would address the problem of overdrafts in times of stress, but even real time monitoring has a number of shortcomings. First, only three Reserve Banks have automated real time monitoring systems in place. The other Reserve Banks rely on manual systems. An automated system is generally necessary to process a large volume of payments. All the Reserve Banks are scheduled to have an automated capability by March of 1987. Until the automated monitoring arrangements are in place at all Reserve Banks, real time monitoring in some Reserve Banks would require that all funds and book-entry securities transfers be processed on an off-line, or manual, basis. Such off-line processing could substantially delay payments while the status of the account was checked and manually updated.

Second, the implementation of real time monitoring would inevitably result in the rejection or delay of funds transfers that would be discernable by the markets and might precipitate problems for the institution, or its affiliates, whose transfers were delayed or stopped. Thus, while solving the problem of the risk created by an individual transaction, real time monitoring creates the potentially greater problem of loss of confidence in monitored institutions and injects an element of instability into the markets.

Third, real time monitoring would not address the issue of book-entry securities overdrafts because they are not subject to overdraft caps. Even if such caps were established, rejection of those transactions destined for a buying-receiving institution would be immediately apparent to the selling-sending depository institution.

In sum, regulatory controls on the relationship between a depository institution and its affiliate either provide illusory protection, *e.g.*, an extension of section 23A to cover overdrafts, or, as in the case of rejection or delay of transfers, while solving certain problems such as the risk from the rejected or delayed transaction, creates greater problems in terms of loss of confidence in the payments system. The risks created by affiliate relationships are most effectively addressed by restricting the potential relationships that arise to those that are subject to ongoing supervision and regulation that will provide prior notice of developing problems and permit regulatory limitations to be tailored to the individual situation.

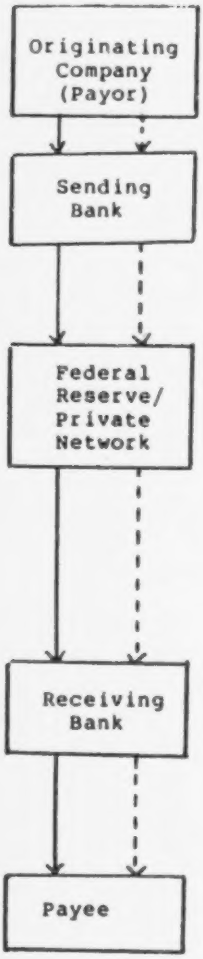
Discount Window Issues

A loan to a depository institution to cover overdrafts of an affiliate, as might occur where a depository institution is established primarily to serve the payments needs of its affiliates, is in effect a loan to the nondepository institution affiliate. Under section 13 of the Federal Reserve Act, loans to nondepository institutions such as individuals, partnerships and corporations on the security of collateral other than United States Government and agency securities can only be made in unusual and exigent circumstances and require an affirmative vote of five members of the Board. Regulation A further specifies that such loans should only be made where failure to do so will adversely affect the economy (12 C.F.R. §201.3(c)). No loans have been made under this authority since the 1930s.

For example, an affiliate may purchase book-entry govenment securities and incur an overdraft at its account at the depository institution. This overdraft may result in an overdraft at the depository institution's account at a Federal Reserve Bank. If the Reserve Bank must ultimately cover the overdraft with a discount window loan to the depository institution, the Reserve Bank has effectively extended credit to the affiliate. The ready extension of credit to nondepository institutions through affiliated banks is contrary to longstanding Congressional policy and would seriously distort the purposes of Federal Reserve credit.

ATTACHMENT A

FUNDS TRANSFER


Originating Company (Payor)
Sending Bank
Federal Reserve/ Private Network
Receiving Bank
Payee

Risk to sending bank

- Risk that customer sending transfer will not have sufficient funds to pay for the transaction.

Risk to Federal Reserve

- On a Fedwire transfer, risk that the sending bank will be unable to cover transfer in its reserve account.
- $40 billion in daylight overdrafts per day.
- Fed could be forced to "rescue" settlement of provate network through discount window accommodation.

Risk to receiving bank

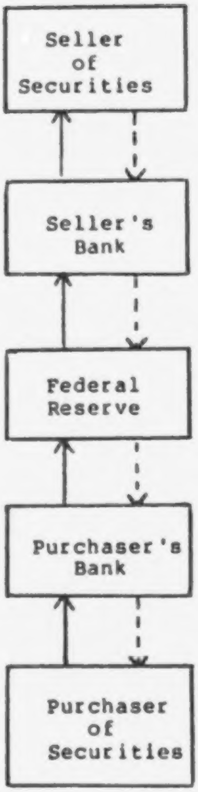
- On a private network, risk that sending bank will be unable to settle at end of day and funds made available to payee might not be recovered.

——————→ Funds flow

---------→ Payments instructions

ATTACHMENT B

BOOK ENTRY SECURITIES



Risk to Federal Reserve

- Risk that there may not be a perfected security interest in the securities being transferred, and the security purchaser's bank cannot cover the amount of securities being purchased.
- Assuming a perfected security interest in the securities, and the securities purchaser's bank's inability to cover, there is a risk that the selling price of the securities would be less than the "purchase" price. (market risk).
- $40 billion in daylight overdrafts per day.

Risk to securities purchaser's bank

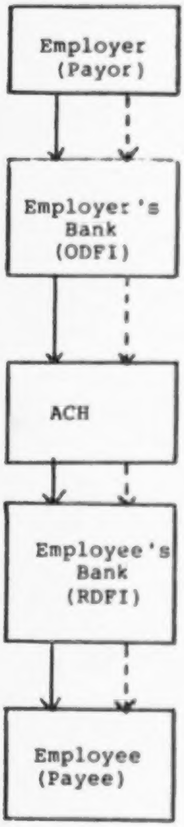
- Risk that there may not be a perfected security interest in the securities being transferred, and the purchaser of the securities cannot cover the amount of securities being purchased.
- Assuming a perfected security interest in the securities, and the securities purchaser's inability to cover, interest rate risk that the securities could sell for less than the amount of the transfer.

———→ Funds flow

---------→ Securities flow

ATTACHMENT C-1

ACH CREDIT PAYMENTS
(Direct Deposit of Payroll)



Risk to originating bank

- Risk that payor will not be able to cover transfer on the settlement date.

Risk to Federal Reserve

- On ACH transactions sent through the Federal Reserve, the Fed may be at risk if the sending bank is unable to cover transfers in its reserve account on settlement date.

Risk to receiving bank

- On ACH transactions not processed through the Fed, risk that originating bank will be unable to settle at end of day and funds made available to payee might not be recovered.

Security risk

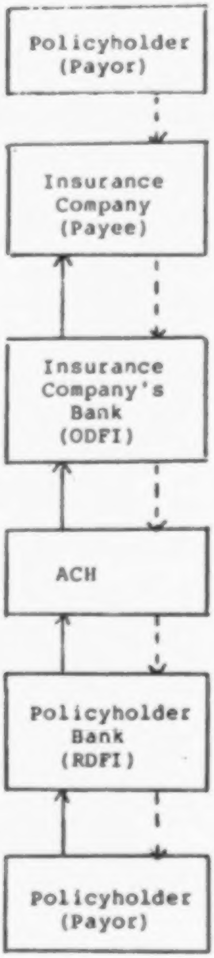
- Since ACH is not a totally electronic environment, it is not as secure as funds transfer networks. Manual controls are less effective than automated controls. Multiple handlings due to physical delivery of tapes result in greater exposure to error and fraud.

————→ Funds flow

----------→ Payments instructions flow

ATTACHMENT C-2

ACH DEBIT PAYMENTS
(Insurance Premium Payment)


Policyholder (Payor)
Insurance Company (Payee)
Insurance Company's Bank (ODFI)
ACH
Policyholder Bank (RDFI)
Policyholder (Payor)

Risk to originating bank

- Risk of payee withdrawing funds prior to finality of settlement, due to possibility that a receiving bank may be unable to settle.
- Risk of payee withdrawing funds before originating bank is assured that debit transfers will not be returned.

Risk to Federal Reserve

- Federal Reserve is at risk on return items destined to a failed institution.

Risk to receiving bank

- No appreciable risk, since receiving bank has until its midnight deadline to return an ACH debit (only risk in failing to return an ACH debit that cannot be posted).

Security risk

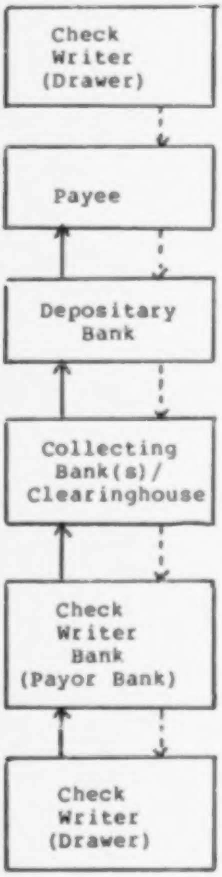
- Since ACH is not a totally electronic environment, it is not as secure as funds transfer networks. Manual controls are less effective than automated controls. Multiple handlings due to physical delivery of tapes result in greater exposure to error and fraud.

———→ Funds flow

---------→ Payments instructions flow

ATTACHMENT D

CHECK COLLECTION


Check Writer (Drawer)
Payee
Depositary Bank
Collecting Bank(s)/ Clearinghouse
Check Writer Bank (Payor Bank)
Check Writer (Drawer)

Risk to depositary bank

- Bank makes funds available to its depositor from check that is dishonored.

Risk to Federal Reserve

- Federal Reserve may be at risk on return items destined to a failed institution.

Risk to payor bank

- Bank does not properly honor stop payment order.
- Bank does not return check drawn on an account with insufficient funds by its midnight deadline.
- Bank pays a check with a forged drawer's signature.

——→ Funds flow

---+-----→ Payments instructions flow

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM DENNIS J. KELLEHER

Question No. 1 from Senator Proxmire:

I know that you, like Mr. Edgerly and Mr. LaWare, believe that the Committee should focus on an agenda broader than what I laid out in my letter asking for your associaiton to testify. Would you not agree, however, that my initial approach makes good public policy sense in that it would re-establish the principle of keeping banking separate from commerce and also give banks some of the additional powers they need to remain viable?

Answer:

We certainly agree that it would be good public policy to permit banking institutions to underwrite and deal in municipal revenue bonds, mortgage-related securities, commercial paper and mutual funds. If permitted to underwrite and deal in these securities, banking institutions would bring much-needed competition to the marketplace, enhance safety and soundness by generating additional fee income, and provide customers with services in a convenient and cost-effective way.

At the same time, we think that modern market conditions -- including the rapid internationalization of the capital markets and the displacement of traditional bank deposits and loans by securitization and non-bank competition -- require Congress to consider broader reform of the nation's financial institution laws. Congress will not assure the maintenacne of a viable, competitive domestic banking system in the long run simply by expanding the permissible securities activities of banking institutions to include four specfic products. That is why our Association supports proposals that would permit holding companies to own both full-service commercial banks and full-service securities firms. Moreover, a bill that expands the permissible activities of both banking institutions and securities firms in this way might attract a broader base of support for passage than have previous bills (approved by the Senate but not by the House) that provided banking institutions alone with some modest additional securities authority.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM DENNIS J. KELLEHER

Question No. 1 from Senator Garn:

Your organization supports allowing any financial firm to get into any financial activity -- banks, securities firms, and insurance companies all getting into each other's business. How do you view the mixture of financial activities -- not just banking -- with commercial activities. Does this present additional problems that are capable of regulation? Should commercial firms be permitted to own non-banking financial firms like securities or insurance companies? In answering these questions, please distinguish between:

A) Banks and financial companies that engage in commerce themselves;

B) Banks and financial companies that engage in commerce through subsidiaries;

C) Commercial companies that have acquired banks and financial companies as subsidiaries; and

D) Holding companies that own commercial companies and financial companies as subsidiaries.

Answer:

Our Association's focus is on securities activities and the reasons that it makes sense as a matter of public policy to permit banking institutions to participate fully in all portions of the nation's capital market. In this connection, we support proposals that would permit a holding company to own both a full-service commercial bank and a full-service securities firm. This proposal would assure equal competition and regulation as well as equal opportunity for securities firms and banks to participate as they considered most sensible in rapidly developing and closely connected financial activites. Because of our focus, we have not yet taken a position, as an Association, on the mixture of commercial activities and banking.

Question No. 2 from Senator Garn:

Isn't is true that banks can already underwrite and deal in the largest part of the mortgage-backed securities market, that is, those with mortgages backed or guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae? What proportion of the mortgage-backed market is comprised of these types of securities? How large is the private mortgage-backed market? Why is the market so concentrated now if banks can already compete in a large part of it? For purposes of bank underwriting, is there a meaningful distinction between securities backed by private mortgages as opposed to ones that are publicly guaranteed?

Answer:

Banks can and do underwrite and deal in mortgage-related securities issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. It has been reported that about $250 million of "federal agency" mortgage-related securities were issued in 1986. Banks and securities firms compete in this portion of the market.

While the legal situation is not entirely settled, banks have generally not underwritten "privately issued" mortgage-related securities. This part of the market has grown enormously in recent years -- from about $300 million in 1980 to nearly $57 billion in 1986. The concentration ratios in this part of the market are very high. For example, the top three firms in the "private" mortgage-related securities market -- all investment banks, of course -- accounted for 61% of the underwriting in 1986, up from 40% in 1984.

We believe that there is no meaningful distinction between the "federal agency" and the "private" mortage-related securities, and that banking institutions should be permitted to underwrite and deal in both types of securities. The credit analysis, pricing, underwriting, and distribution skills needed to participate successfully in the "federal agency" part of the market -- as banks do today -- are identical to the skills needed to participate successfully in the "private" part of the market. Indeed, the "federal agency" part of the market includes securities issued by Fannie Mae, which is a privately-owned, for profit corporation whose stock is listed on the New York Stock Exchange -- yet banks underwrite these securities safely and profitably every day.

Question No. 3 from Senator Garn:

Would you comment on the trend of securities firms to use more and substantial amounts of their own capital in financing mergers and acquisitions? How risky is this, and should banks be allowed to engage in similar activities?

Answer:

The financing of acquisitions by securities firms is another example of the blurring of the ancient lines between securities activities and banking activities. Typically, the financing involved is a loan by a securities firm to facilitate the acquisition; the loan could be repaid by a public or private offering of debt or equity, or in other ways. In either event, the ability of a securities firm to provide financing of this sort serves a client need that would otherwise be served by banks or other institutions.

We see no reason to prohibit either banks or securities firms from providing this type of financing. The risk of a loan of this sort, like the risk of any other loan, has to be analyzed carefully by the lender, taking into account the business and prospects of the borrower, the collateral available and other relevant factors. There is no reason to believe that such loans are necessarily more (or less) risky than other sorts of permissible loans by commercial banks. Any such loan by a bank would, of course, be subject to limits based on the bank's capital, as well as the prudential requirements of the bank regulators and, if legislation like that proposed last year is adopted, additional requirements in new Section 23B of the Federal Reserve Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM JOHN P. LAWARE

Q. 1. The association you represent is part of the so-called Mayflower Group, which includes not only banks and other companies "financial in nature" as defined in your statement, but also commercial firms with nonbank banks, such as General Motors, Chrysler, Sears and J.C. Penney. Your concept of a financial services holding company would not include those commercial firms, would it? If not, what is the reason for your alliance with these companies now?

A. As was indicated in our testimony, the Association is working on a financial services holding company proposal. The proposal, while not yet in completed form, has been approved by the Association's Legislative Policy Committee and Executive Committee.

In approving the concept, the Executive Committee provided for the necessary flexibility to allow the Association to negotiate with as many financial intermediaries as possible. Hopefully, these negotiations will result in a broad base of support for the concept. As is the case in any negotiation process, the final product may differ from the current version. The final product will be approved by the Association's annual meeting in May.

With the foregoing in mind, your observation that the Association's current draft proposal does not permit such commercial firms as Sears, J.C. Penney, General Motors and Chrysler to organize a financial services holding company is accurate. We will, however, be discussing the proposal with all companies currently engaging in the financial services business, including the previously mentioned commercial firms. Hopefully, as a result of these discussions, our proposal will be fashioned in such a way that it will attract the broadest possible support in its final form.

This brings us to the issue of the Association's involvement in the Mayflower Group. As is painfully evident to all of us, the inability of the Congress to fashion progressive and comprehensive financial services legislation has put U.S. financial intermediaries at a distinct disadvantage on the world markets. In an effort to effect the broadest possible coalition to support the enactment of needed legislation, the Association joined other firms in the financial services business. This group commonly known as the "Mayflower Group", meets periodically and is striving toward obtaining a broad general concensus on banking legislation that all can support.

The concept behind the Mayflower Group has been endorsed by the Treasury Department, distinguished members of Congress, and was favorably mentioned in President Reagan's written State of the Union message to the Congress. The jury is still out whether this group can successfully obtain its goal of comprehensive, pro-competitive legislation. Nonetheless, success cannot be ruled out, thus making the effort worthwhile.

For your information, we are attaching a copy of the Mayflower Group's statement of Principles issued on January 20, 1987. The Association was one of the signers of this statement and endorses these principles. We would appreciate it if you would include this statement as part of our answer to this question.

The Mayflower Group

General Principles

Objective

To unite a diverse group of financial service intermediaries behind the common legislative goal of an open and competitive marketplace for financial services which ensures the safety and soundness of the nation's financial system as well as the availability of innovative financial products and services for consumers, business and government at the lowest possible cost.

General Principles of Agreement

- Outdated statutes and regulations inhibit innovation, efficiency, and competition in the financial services industry to the detriment of providers and consumers.

- Financial services legislation must be comprehensive and pro-competitive. Existing laws that restrict competition should be modernized. A new legal framework for financial services should be created which will accord all financial service companies equal opportunity to serve the full range of credit and financial needs in the marketplace.

- Expanded product and service opportunities for all components of the financial services industry would strengthen individual intermediaries as well as the overall financial system.

- Rapid globalization of the financial services marketplace and the emerging interdependence of major financial markets further underscore the necessity of modernizing domestic laws to maintain the competitiveness of U.S. intermediaries and the preeminence of U.S. financial markets.

- Regulation of separate segments, subsidiaries and affiliates along functional business, product and service lines without regard to ownership and control would serve national priorities better than the present system. Functional regulation would foster diversification by financial intermediaries, promote fair competition and assure equality of regulation. Holding company supervision should be minimal, residual in nature, and then related only to specific goals of public policy.

Affirmed on January 20, 1987 by the attached listing of signators.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM JOHN P. LAWARE

Q. 1. Would you comment on the potential problems raised by the Federal Reserve Board concerning the blending of banking and commerce. How do you define commerce? Do all forms of financial intermediation not permitted to bank holding companies fall into the commerce category? If Congress determines that banking should be separated from commerce. Don't we need to be able to define both terms?

A. We are aware of the concerns of the Federal Reserve Board with respect to the separation of banking and commerce. As pointed out in our testimony, the Association is currently developing a Financial Services Holding Company concept. The issue of the demarcation between banking and commerce is one aspect of this new concept that we are currently evaluating. When we have completed our evaluation, we will be happy to share our findings with the Congress. Our tentative conclusion is that there is merit in the Board's position and we do believe that there should be a congressional recognition of a separation between the two, however defined.

Q. 2. Over the past fifteen years there appears to have been a distinct change in the profitability of the basic wholesale banking business as noted in the report recently completed by the Federal Reserve Bank of New York. I would be interested in your comments on the future viability of the banks referred to in that report.

A. We share the concern of the Federal Reserve Bank of New York over the deterioration of bank profitability in some areas. This finding makes even more important and urgent the need for the Congress to pass comprehensive financial services legislation, to make more equitable the competitive situation among financial services organizations.

Q. 3. I believe that about 15 years ago, 7 out of the top 10 largest banks in the world were U.S. banks and today only one of the top 10 banks in the world is a U.S. bank. I'd like your views on why the growth of U.S. banks relative to the growth of other banks has slowed down so dramatically.

A. The statistics you cite in this question are further evidence of the inability of banking institutions in this country to compete in the world markets because of archaic and constrictive laws. For example, there is no way that domestic banks can compete with foreign banking institutions in light of the Glass-Steagall constraints imposed on domestic banks. Unfortunately, the situation will only get worse unless Congress takes decisive and early action to make the competitive situation more equitable.

Q. 4. As you know, several U.S. money center banks have been in the business of underwriting corporate securities in Europe for a number of years, and as far as I know, they have done so without any particular problems or threats to the safety and soundness of the parent institution. If this is true, what is wrong with letting them underwrite corporate securities in the U.S. market?

A. There is nothing wrong with allowing domestic banking institutions to underwrite corporate securities in the U.S. market. As a matter of fact, the Association advocates in its Financial Services Holding Company concept allowing such companies to operate both insured depository institutions and securities firms in separately capitalized and insulated subsidiaries.

Q. 5. The United Kingdom and Canada have recently taken substantial steps toward protecting the viability of their securities and capital markets by undertaking a significant restructuring of their financial system. Japan is currently discussing taking similar steps. Shouldn't the U.S. be undertaking the same major restructuring so that in the long run its capital and securities markets don't get left behind?

A. As we indicated in previous answers, if the United States wants to keep its financial services organizations competitive in the world markets, a major restructuring of the financial services laws in this country will have to be accomplished. The longer it takes the Congress to accomplish this task, the more will be the negative impact on domestic banking competitiveness.

Q. 6. I would like to return for a moment to the European underwriting affiliates already owned by many of our largest money-center banks. Isn't it possible that if we don't make our regulatory system more flexible, many of these money-center banks will have no choice but to move an increasingly larger percentage of their activities abroad. Thus costing the U.S. jobs, capital and tax revenues?

A. We agree that without changes in the financial services regulatory structure the money center banks will have no choice but to move an increasingly larger percentage of their activities abroad, costing the United State jobs, capital and tax revenues. As a matter of fact, this trend is becoming evident.

Q. 7. Earlier, reference was made to the major restructuring of financial markets undertaken by the United Kingdom and Canada which they view as necessary to protect jobs and increase competition. Over the years there has been an influx of foreign banks to New York, the major domestic financial market, which has improved New York's economy. Isn't it likely that significant deregulation in the U.S. will mean more jobs in the U.S. financial services sector as foreign institutions increase their presence here and less loss of jobs for U.S. banks?

A. A restructuring of the financial services laws in this country will make domestic banks more competitive with foreign competition and thus result in less loss of jobs for U.S. banks.

Q. 8. The banking industry, including the small banks, is facing increased pressure from competitors which have greater flexibility to respond to a dynamic market with products like the securitization of car loans and the securitization of consumer credit receivables. Do you see any way in which we can keep our banking system healthy and competitive without substantially altering the current regulatory structure to permit full competition among the financial services providers?

A. No, we do not see any way that we can keep our overall banking system healthy and competitive without substantially altering the current regulatory structure to provide full competition among financial services providers.

Q. 9. The capital raising mechanism in this country is becoming increasingly centered in New York. Wouldn't it make sense to improve the capital-raising abilities in other areas of the country by permitting the banking system, under proper regulation, to compete in this market?

A. More competition in the capital raising market would be beneficial and we favor the broadest possible geographical market in this respect.

Q. 10. Does the high degree of concentration which currently exists within the investment banking industry and excessive profits earned by those firms, cause any concern that there needs to be greater competition in those markets? Wouldn't banks and other financial services providers be natural entrants in that market? If U.S. banks are prohibited from entering, isn't it more likely that instead of losing market shares to U.S. banks, securities firms will instead lose shares to foreign securities firms and foreign financial intermediaries?

A. The Association favors the broadest possible competition in the financial services marketplace. Consistent with that premise is the notion that commercial banks should be allowed to compete in the investment banking area through a Financial Services Holding Company network. Otherwise, as you point out in your question, foreign financial intermediaries will be the chief competitors.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
CHARLES T. DOYLE

Question #1

In your statement, you express concern over the expansion plans of Ford Motor Company's subsidiary, First Nationwide. Is your concern that this thrift's plan to open outlets in K-Mart stores will threaten the thrift industry, the payments system or what?

Response:

In my written statement, I outlined five specific objections of the IBAA to the nonbank bank and nonthrift thrift loopholes. Those objections are: (1) they breach the separation between banking and commerce set forth in federal law; (2) they undermine the right of the states to determine their own financial structure; (3) they give loophole holding companies access to the payments system; (4) they are an abuse of and a threat to the federal deposit insurance system; and (5) they take credit away from local small business. Each of these serious concerns is raised by the plans of First Nationwide to operate in K-Mart stores across the nation.

Question #2

Given your concern that commerce be separated from the credit-granting process, do you object to GM's ownership of GMAC and Ford's ownership of Ford Motor Credit? How do you define commerce - is it simply those activities not permitted to bank holding companies?

Response:

The IBAA still believes in the importance of separating commerce from banking. While we may have concerns about the credit-granting activities of GMAC and Fort Motor Credit, those operations are not seeking the benefits of the payments system and the federal deposit insurance programs. This is a clear distinction from commercial firms which seek those important benefits in the form of a nonbank bank or nonthrift thrift.

Question #3

It has been suggested that we should close the "nonbank bank loophole" but that it would be too politically difficult to close the "unitary thrift loophole." What would be the result of closing the former but not the latter?

Response:

To close the nonbank bank loophole but not the unitary thrift loophole would be only a partial and unacceptable solution to the problems posed by these institutions. In particular, it makes little sense to recapitalize the FSLIC fund if the nonthrift thrift loophole remains open. Fed Chairman Volcker, FHLBB Chairman Gray and FDIC Chairman Seidman all testified before the Committee that closing both loopholes is a vital element of any FSLIC recapitalization. Unless the loopholes are closed, what incentive is there to buy an ailing thrift?

Sincerely,

Charles T. Doyle

Charles T. Doyle
President

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM CHARLES E. RICE

Dear Chairman Proxmire:

I testified before your committee on January 22, 1987 on behalf of the Coalition for Regional Banking. On February 6, you sent to me four specific questions from Senator Jake Garn, seeking additional information for the committee.

I am pleased to reply to that request.

> Question 1: Your organization supports FSLIC recap, but opposes merger of the insurance funds and exit fees on institutions that want to change from FSLIC insurance to FDIC insurance. If these institutions should begin to leave, depriving the FSLIC of much-needed premiums, there may not be enough resources to take care of failing thrifts. Would you then support a taxpayer bail-out rather than a merger of the funds?
>
> Answer 1: Our organization does support FSLIC recapitalization, but opposes merger of the insurance funds and exit fees on institutions that want to change from FSLIC insurance to FDIC insurance. We oppose exit fees because they would inevitably trap the healthy thrifts, which constitute the vast majority, in a more-and-more costly deposit insurance program, brought about by the gross mismanagement of the small minority of thrifts which have incurred huge negative net worths without any adequate control from the Federal Home Loan Bank Board.
>
> Neither are we convinced that there is likely to be a heavy exit from FSLIC by healthy thrifts. The few conversions which have occurred over the past year or so characteristically show continuous payment of insurance premiums to a government sponsored agency - from FSLIC to FDIC, so there is no net loss of premium revenue to the government. We believe the few conversions to date represent free marketplace decisions and are not caused by the plight of individual thrifts and have little or nothing to do with the overall difficulties that FSLIC presently faces. In recent meetings with representatives of the National Council of Savings Institutions, both Chairman Grey and Under-Secretary of the Treasury Gould said they did not anticipate a significant "flight from FSLIC". Mr. Gould is reported to have said that a mass exodus was not likely and he did not appear concerned if a small number of institutions did, in fact, convert to FDIC insurance.

In a recent letter to Chairman St. Germain, Under Secretary Gould wrote:

"First, I should stress than an exit fee is not essential to the financial integrity of our FSLIC recapitalization plan... Also, Federal Home Loan Bank Board analyses have shown that at least 15% of the thrift industry's assets could leave the FSLIC while leaving it with positive reserves and without requiring any change in the phase-out of the special assessment."

We do not feel that a taxpayer bail-out of FSLIC would be necessary, nor would it be politically feasible.

Question 2: Do you believe a delay in recapitalizing FSLIC increases the likelihood that a merger of the funds will be necessary?

Answer 2: Our organization believes that a reasonable delay in recapitalizing FSLIC, to enable both Houses of Congress to identify and adopt the very best plan available, is feasible and creates no imminent danger. However, the recapitalization plan should be adopted and in place before the end of this session.

Question 3: Your suggested modifications to the regulators' bill would keep the threshold for emergency acquisitions at $500 million, with limited exceptions. Doesn't this deprive the FDIC of authority in the states that would most benefit from it, i.e., states with restrictive branching laws that limit the size of institutions, where the banks that fail are smaller and unlikely to attract in-state buyers?

Answer 3: Our organization suggests keeping the threshold for emergency acquisitions at $500 million, with limited exceptions. We have no objection to removing that size limitation altogether if the FDIC has difficulty in attracting in-state buyers willing to make reasonable acquisition bids. However, the expansive-minded money-center banks will use this emergency acquisition procedure to buy into attractive markets, such as the southeastern states, and will pay exorbitantly high prices to do so. In such markets there is no shortage of reasonable, adequate and fairly priced bids from a number of in-state bidders. Furthermore, with the large recent increase of states permitting regional or national inter-state banking, this problem becomes less and less significant. The windfall extra price sought by the FDIC is at the expense of near total obliteration (by indirection) of the remaining geographic limitations of the Douglas Amendment.

Question 4: As of January, 1987, how many financial institutions are members of "The Coalition for Regional Banking"? In what states are those members domiciled?

Answer 4: Six regional bank holding companies and the Florida Bankers Association are presently members. The holding companies own full service banks in the following states:

Connecticut
Delaware
Florida
Georgia
Maine
Maryland
Massachusetts
Rhode Island
South Carolina

Very truly yours,

Charles E. Rice

Charles E. Rice

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM CHARLES E. RICE

Q: **Your organization supports FSLIC recap, but opposes merger of the insurance funds and exit fees on institutions that want to change from FSLIC insurance to FDIC insurance. If these institutions should begin to leave, depriving the FSLIC of much-needed premiums, there may not be enough resources to take care of failing thrifts. Would you then support a taxpayer bailout rather than a merger of the funds?**

A: We would reiterate our support for the recapitalization of FSLIC. We do not consider ourselves expert enough to determine the effectiveness of the various plans submitted to the Committee by either the government or thrift organizations; however, we do recognize that all involved stress the need for prompt action and seem to differ only on the amount and length of the recapitalization program.

We would point out that the number of conversations from FSLIC to the FDIC in the last eighteen months have involved no more than twenty-five institutions and that these conversions characteristically show continuous payment of insurance premiums to a government-sponsored insurance agency -- whether it be FSLIC or the FDIC. In light of this limited number of transactions, the effect on the total amount of current insurance premiums is negligible. We believe conversions to date represent free marketplace decisions and are not caused by the plight of individual thrifts or the overall difficulties that FSLIC presently faces.

We do not realistically envision the need for a tax payer bail-out or the merger of the funds, if the Congress acts promptly on a FSLIC recapitalization plan and other needed provisions; most importantly, the closure of the "non-bank" bank loophole.

Q: **Do you believe a delay in recapitalizing FSLIC increases the likelihood that a merger of the funds will be necessary?**

A: We believe, and have stated in our testimony, that recapitalization is necessary. The reserve level of FSLIC will have to be replenished and it can be argued that the sources of the money needed must be developed regardless in which account the funds are held. If the current short fall is projected at approximately $20 billion, it is logical to assume that this level of funding will be needed for the thrift industry. Since insurance premiums are still needed an eventual recapitalization program is the most straightforward way of accomplishing such replenishment and consideration of merging the funds does not address the basic problem.

Q: **Your suggested modifications to the regulators' bill would keep the threshold for emergency acquisitions at $500 million, with limited exceptions. Doesn't this deprive the FDIC of authority in the states that would most benefit from it, i.e., states with restrictive branching laws that limit the size of institutions, where the banks that fail are smaller and unlikely to attract in-state buyers?**

A: In our testimony, we supported the exception which would liberalize the current Garn-St Germain emergency acquisition standard of $500 million, i.e., broadening the standard to include the five largest institutions in any state, regardless of the current threshold. With that proposed relaxation and full knowledge of the actions by the individual states in allowing both intra-state and interstate mergers, we feel that adequate flexibility is afforded the regulators in solving the failed bank problem. In light of the actions taken by the states to address the troubled bank situation, we continue to subscribe to the principle that no institution is "too big to fail", or by extension, no institution is "too small to fail".

Q: **As of January 1987, how many financial institutions are members of "the Coalition for Regional Banking"? In what states are those members domiciled?**

A: Six regional holding companies and one state bankers association have already renewed their membership for 1987. The holding companies own full service banks in the following states:

Connecticut
Delaware
Florida
Georgia
Maine
Maryland
Massachusetts
Rhode Island
South Carolina

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
MARK W. OLSON

February 19, 1987

Q1. It has been suggested that expanded products and services would benefit only the largest banks and that smaller banks would have to merge with others in order to be able to offer the new products and services. Mr. Olson, you are not from a money center bank. Why do you think banks like your own would benefit?

A1. Community banks would benefit in many ways. The ability to sell insurance and real estate would give them major opportunities to diversify their sources of income and meet customer needs. As securitization proceeds, their traditional on balance sheet lending markets will shrink. The ability to originate loans for securitization in a market where such securities are broadly distributed, as they would be if they were underwritten by banks, would be beneficial. The ability to sell such securities to local customers would create an added opportunity to enhance profitability and meet customer needs. The ability to underwrite municipal revenue bonds would be particularly useful for many community banks. For example, in order to purchase a revenue bond of my local county government, I have to contact a broker in St. Paul, a considerable distance away. Finally, it is clear that mutual funds are an attractive product for people everywhere. We could satisfy those demands for people in my hometown in ways that securities firms never could. We would like to do it.

Q2. The federal bank regulators proposed eliminating the $250 million asset threshold proposed last year to determine which failed or failing banks could be sold interstate. Would you support the regulators proposal to make all banks, regardless of size, eligible for interstate sale?

A2. When our Association reviewed the regulators bill, there was considerable discussion of the reduction in the size of banks that could be acquired across state lines from the $500 million threshold contained in the Garn-St Germain Depository Institutions Act of 1982 to the $250 million level proposed. The Association voted to support the reduction to $250 million.

At the same time, however, there was considerable sympathy expressed for the notion of reducing that figure further, perhaps even to zero. It was agreed that, because the regulators had not, at that time, asked for a lower threshold than the $250 million proposed, it was not necessary for the Association to take a position on a lower threshold. Nevertheless, we would not oppose the lowering of the $250 million threshold further. To the extent the regulatory agencies need the authority to adequately deal with failed or failing banks, the American Bankers Association will generally be supportive.

Nevertheless, our Association is concerned that any authority that is granted to the regulatory agencies to deal with failing or failed banks not become a means for evading state-imposed restrictions on the geographic locations of banks. We would therefore oppose any efforts to provide a broad grant of authority to the regulatory agencies to authorize interstate acquisitions that would, in effect, override the Douglas Amendment.

Q3. Some observers have suggested that the securities powers for banks under consideration today are intended "to expand the functions of banks." Your statement seems to argue that those securities powers would merely preserve the traditional role of banks in the provision of commercial credit, in the provision of credit to state and local governments, and in the mortgage markets. Is that correct?

A3. The question of whose traditional functions are expanded or contracted is not the most relevant one to focus on. More important is the question of how needs for financial services are being met. Today their are new and more efficient instruments available for meeting traditional needs. Commercial paper is the functional equivalent of a loan. Why should banks be prohibited from underwriting it? A money market mutual fund is the functional equivalent of a bank deposit. Why should banks be prohibited from sponsoring and selling mutual funds? Customers want the alternative of banker expertise and banking's distribution systems to obtain the services they need. Banks should be able to provide them.

Q4. In the last few years, several states have passed check hold legislation. The availability schedules that have been established under these laws have been tied to the actual time it takes for a check to be returned unpaid. What would be the potential losses to the banking system if the federal government mandated availability schedules shorter than the time it takes various types of checks to be returned unpaid?

A4. The specific amount of potential losses to the banking system if the government mandated availability schedules shorter than the time it takes to know whether a check is collectible is speculative. However, existence of such schedules most certainly will increase criminal activity in areas such as check kiting, check counterfeiting, and check fraud. The schedules will serve as an invitation to those with a propensity for such schemes.

As an example of check fraud, assume a person opens accounts at two banks and maintains the accounts for the period required to satisfy any new account exception permitted under the schedule. Suppose the person writes a check against nonsufficient funds for 5,000 (assuming this is less than any large dollar check exception) on his account in Bank 1 and deposits it in the account in Bank 2. The person may withdraw the funds from Bank 2 at whatever time the schedule dictates, but before Bank 2 can know whether the check is collectible.

Later, after the person has withdrawn the $5,000 from Bank 2, Bank 1 returns the check unpaid. Since Bank 2 cannot obtain from the person, Bank 2 loses $5,000.

Q5. Is it possible to be sufficiently precise about the check-return technology that will be available over the next five or ten years to justify legislating availability schedules now?

A5. ABA has worked with the Federal Reserve toward an improved and more efficient return system. The Federal Reserve's recent pilot return check program has shown great promise in shortening the return check process. One of the greatest obstacles to its ultimate implementation and success has been the Board's lack of authority to require that all checks, whether or not they clear through the Federal Reserve System, be subject to the pilot return process. Senator Dodd's funds availability bill, S.344, empowers the Board to override any state law, including the Uniform Commercial Code, which the Board determines to be inconsistent with the Act.

We believe that given the positive results of the pilot program and with the regulatory authority granted the Board in S.344, a more efficient check return processing system may be available within the next five years or so. Nevertheless, the precise workings of such a system cannot be predicted at this time; and that is the reason that the Federal Reserve Board must be given some flexibility in designing availability schedules.

Q6. If mandated availability schedules were to expose banks to serious potential losses, what is the danger that depository institutions would stop offering checking accounts to the very people delayed-funds-availability legislation was intended to help? Do mandated and publicly available check hold schedules encourage fraud?

A6. The danger certainly exists that due to exposure to serious losses resulting from mandated availability schedules, depository institutions will be compelled to provide checking accounts only after a substantial credit evaluation. Providing access to funds before knowing whether or not they are collectible is essentially providing a loan. Thus, applying to open an account would become equivalent to applying for a loan.

Since many of the people wishing or needing immediate access to deposited funds are less likely to qualify for a loan, they would find it more difficult to open an account.

Q7. Why is public disclosure of individual institutions' availability schedules not sufficient to protect consumers from unreasonable holds?

A7. The feeling among most bankers is that disclosure of availability schedules is sufficient to protect consumers. Banks operate in a highly competitive marketplace. They cannot afford to irritate or confuse customers with undisclosed or burdensome hold policies. The market dictates that they be aware of customer concerns, inform them of policies that affect them, and be flexible enough to accommodate their needs. If banks do not, customers will walk across the street to the competition.

Further, very often complaints have arisen when a check has been held unexpectedly because the customer is accustomed to immediate access and is unaware of the hold policies that justify the hold. When customers are informed of the hold policies, they may plan accordingly and in many cases can avoid problems by the use of available alternatives such as the wire transfer of funds.

Q8. One argument that has been advanced for mandating shorter availability schedules relates to the fact that banks often receive provisional credit for checks being collected before the banks make the funds available to their customers. As soon as the banks receive provisional credit, they can begin earning interest on the funds, but if consumers have deposited the checks in demand deposits, they must wait until the end of the availability schedule before investing in interest-earning assets. With the increasing use of NOW Accounts, which pay interest on funds from the date of deposit, has the need for funds-availability legislation been reduced? Don't the vast majority of banks pay interest on deposited checks from the day of deposit or the day the bank receives provisional credit?

A8. The vast majority of banks have always paid interest on deposited checks from the day of deposit or the day the bank receives provisional credit. The issue has really been access to funds, not unpaid interest.

If a hold is placed on a check, the customer may not withdraw the funds during the period of the hold, but generally still receives interest for that period.

Q9. If a customer needs quick availability of his money, to what extent can wire transfers be substituted for check payments?

A9. Complaints of funds availability would diminish considerably if electronic funds transfers were used instead of checks. They are an appropriate substitute in many instances. For example, direct deposit is available for recurring payments such as work, social security, or government benefit checks. Customers may withdraw funds on payday as scheduled.

Similarly, one-time wire transfers of funds is useful, for example, when a customer changes depository institutions, moves to a new city, buys a house, or wishes to send money to a child at college. In all these cases, the money is generally available to the customer upon completion of the electronic transaction.

Q10. If a consumer needs quick availability of his money, would it be reasonable to require the consumer to establish a credit line with his bank equal to the amount of credit he wants on check deposits before the expiration of the time it takes for those check to be returned unpaid?

A10. Yes, it may be reasonable for banks to offer consumers a credit line with their bank equal to the amount of credit they want on check deposits before the expiration of the time it takes for those checks to be returned unpaid. Many banks currently offer "no-bounce" checking: an optional line of credit linked to a checking account.

Q11. For consumers, how do the average length of check holds with credit unions and savings and loans compare with that of commercial banks?

A11. We believe that credit unions and savings and loans generally place longer check holds than commercial banks. ABA has not conducted any surveys to document this. However, other studies and surveys support this conclusion. For example, a study undertaken by the New Jersey Department of Banking and released in September 1984, showed that the average check hold period for savings banks and savings and loans was twice the length of the average hold placed by commercial banks.

Q12. Should check hold legislation apply to money market mutual funds as well as banks?

A12. Check hold legislation should indeed apply to money market mutual funds as well as banks. Since the 1970's, several hundred money market funds have appeared in the marketplace. These funds hold over 175 billion dollars in over 12 million accounts, most of which have transaction capability similar to a checking account. To protect all users of checks and check-like instruments, it seems only fair and equitable to apply any funds availability legislation to all financial service providers who offer check or check-like services. Consumers should not be denied protections simply because of their choice of financial institution.

Q13. Over the past fifteen years there appears to have been a distinct change in the profitability of the basic wholesale banking business as noted in the report recently completed by the Federal Reserve Bank of New York. I would be interested in your comments on the future viability of the banks referred to in that report.

A13. The report correctly points out the problems of large wholesale banks which compete directly with nonbank financial service providers. Without additional product and service authority they will continue to lose customers and, hence, profits. Whether this will ever threaten their viability or the viability of the banking system is difficult to say. What is clear is that there is no need for such a threat to occur. Customers will benefit and the system will be strengthened by giving banking companies the ability to meet perceived needs in the most efficient manner.

Q14. I believe that about fifteen years ago, seven out of the top ten largest banks in the world were U.S. banks and today only one of the top ten banks in the world is a U.S. bank. I'd like your views on why the growth of U.S. banks relative to the growth of other banks has slowed down so dramatically.

A14. The regulatory climate has been particularly favorable for Japanese banks. Their capital ratios are significantly lower than those of U.S. banks. Also, at a time when entry into U.S. markets has been very easy for Japanese banks. Entry into Japan has been difficult, although this situation has improved somewhat in recent years. The high domestic savings rate in Japan has also facilitated expansion of its banking system. At times the value of the yen/dollar has also facilitated its expansion. At least as important as all of these factors have been domestic regulatory restrictions which have hampered the growth of U.S. banks. Product and service restrictions have been particularly important as the development of commercial paper markets and loan securitization has shrunk banking's traditional lending markets and customers have demanded newer financial products.

6
Garn -- Olson

Q15. As you know, several U.S. money center banks have been in the business of underwriting corporate securities in Europe for a number of years, and as far as I know, they have done so without any particular problems or threats to the safety and soundness of the parent institution. If this is true, what is wrong with letting them underwrite corporate securities in the U.S. market?

A15. Our Association has not officially addressed the question of unlimited authority to underwrite corporate securities beyond what was discussed in our testimony. However, the fact that they have successfully underwritten corporate securities for years in overseas markets would certainly seem to indicate that they could do it with no problems at home. The U.S. economy would also benefit from bringing the jobs and business operations associated with such activities into home markets.

Q16. The United Kingdom and Canada have recently taken substantial steps toward protecting the viability of their securities and capital markets by undertaking a significant restructuring of their financial system. Japan is currently discussing taking similar steps. Shouldn't the U.S. be undertaking the same major restructuring so that in the long run its capital and securities markets don't get left behind?

A16. The restructuring of securities and capital markets in Canada and the United Kingdom was taken with the viewpoint of increasing competition. Among other things, fixed commissions were eliminated in the United Kingdom. In Canada, banks were allowed to acquire brokerage firms. In the United Kingdom, banks are already allowed to underwrite corporate securities. These developments will make their capital markets much more efficient than ours. We need to catch up.

Q17. I would like to return for a moment to the European underwriting affiliates already owned by many of our largest money center banks. Isn't it possible that if we don't make our regulatory system more flexible, many of these money center banks will have no choice but to move an increasingly large percentage of their activities abroad, thus costing the U.S. jobs, capital and tax revenues?

A17. Some money center banks have already moved some of their capital markets activities overseas with concomitant loss of U.S. jobs and tax revenue. The trend will continue unless our markets are restructured to give domestic companies the same authority. Such a restructuring will also greatly benefit smaller U.S. companies and smaller U.S. banks which cannot afford to set up overseas operations.

Q18. Earlier, reference was made to the major restructuring of financial markets undertaken by the United Kingdom and Canada which they view as necessary to protect jobs and increase competition. Over the years there has been an influx of foreign banks to New York, the major domestic financial market, which has improved New York's economy. Isn't it likely that significant deregulation in the U.S. will mean more jobs in the U.S. financial services sector as foreign institutions increase their presence here and less loss of jobs for U.S. banks?

A18. Yes. Deregulation of financial markets here will stem the artificial exodus of firms and employment to overseas markets. The overall efficiency of world wide financial markets will increase, as will jobs in the U.S.

Q19. The banking industry, including the small banks, is facing increased pressure from competitors which have greater flexibility to respond to a dynamic market with products like the securitization of car loans and the securitization of consumer credit receivables. Do you see any way in which we can keep our banking system healthy and competitive without substantially altering the current regulatory structure to permit full competition among the financial services providers?

A19. If the regulatory system is not altered to let banking companies offer the wider array of products and services we discussed in our testimony the current trend toward a decline in profitability will continue. This will weaken the banking system and make its products less competitive with those offered by nonbanking companies. This in turn will cause continuing problems for regulators who are responsible for supervising those institutions and assuring their continued health.

Q20. As you are well aware, many issues concerning "conflicts-of-interest" have been raised over the years going all the way back to the Glass-Steagall Act. Is there any evidence that the domestic underwriting and dealing activities currently engaged in by banks has lead to any concerns about the safety and soundness of those banks or the banking system?

A20. Potential conflicts of interest exist in all financial businesses, including investment banking and securities brokerage, and there is no evidence that the current underwriting activities of banks has endangered the safety and soundness of those banks or the banking system.

Potential conflicts of interest that exist today, or would exist with further integration of banking and securities markets, can be adequately regulated by current laws and regulations and the competition of the marketplace.

Federal securities laws and regulations, which would apply fully to a bank securities affiliate, control conflicts that could exist when a firm underwrites and sells securities and provides investment advice. An abuse of a potential conflict is simply bad business because any short term gain would be canceled out by the long term loss of reputation, good will, and client confidence. Some have suggested that banks might "dump" in their trust accounts securities which they underwrote but could not sell. This allegation ignores that fact that such a practice is prohibited by trust law and policed by the courts and bank regulatory authorities.

It has also been suggested that a bank affiliate might underwrite a securities issues merely to obtain repayment of a loan the bank had made to the issuer. If this were attempted the affiliate would be subject to the securities laws' civil and criminal liability provisions unless all material facts about the issuer's financial condition and the use of the offering's proceeds were disclosed.

Another allegation has been that banks might tie corporate underwriting to commercial lending. Such a tie-in may be accomplished only where a near monopoly of one product exits. In the highly competitive situation that would exist with the integration of banking and securities markets such a monopoly would be impossible to attain.

While entry of bank holding companies in the underwriting market will make the securities markets more competitive, there is no reason to believe banks will dominate. The commercial bank share of the private placement market has never exceeded 10 percent. Banks have not overrun the general municipal obligations market where they have participated for many years. In 1986 the top fifteen managers of general obligation issues included only seven banks accounting for only 27.3 percent of the dollar volume of all the issues managed. Similarly, U.S. commercial banks have not dominated the international securities market despite their active participation as underwriters and distributors in debt and equity securities. Such markets are highly competitive.

Who will benefit from the added competition created by the integration of domestic banking and securities markets? Customers will be beneficiaries of new services and cost savings that are products of an active, competitive market.

Securities firms and banks cannot avoid risk. Their role in the economic system is to analyze and manage risk. Traditional bank lending itself is an inherently risky activity. It involves credit risk because a bank must appraise the borrower's ability to repay. It involves market risk because the bank holds on to a loan until it is repaid. During that time economic conditions can change substantially.

Underwriting also involves risk: principally that the securities will decline in value during the very short period they are held by the underwriter. Underwriters are able to spread risk through the use of syndicates which distribute the securities offerings.

Because an underwriter's exposure to risk is limited to a day or two at most and spread through the members of a syndicate, risk is minimized. In fact, a 1982 offering of Kodak shares became the largest single loss in a syndicate underwriting in a decade when one underwriter lost approximately $5 million. That amount pales in comparison to loan losses experienced by major banks without having their stability impaired. Furthermore, a separately incorporated securities affiliate, independently capitalized in accordance with the SEC's standards, would impose no added risk to the bank itself.

Nor are banks neophytes when it comes to underwriting. They have a long history of participation in the underwriting market for general obligations of state and local government obligations. Banks have successfully competed in this market where the bonds have a local character and lack volume and trading frequency for a national market.

Underwriting securities and extending credit are both risky activities. There is no evidence that underwriting is more risky than extending credit. Banks have done some types of underwriting and a general loan business for years without impairing the safety and soundness of the banking system. If their underwriting authority is further expanded, as we have proposed, their income base would be stronger and more diversified and the strength of the system would improve.

Q21. The capital raising mechanism in this country is becoming increasingly centered in New York. Wouldn't it make sense to improve the capital raising abilities in other areas of the country by permitting the banking system, under proper regulation, to compete in this market?

A21. Allowing banking companies to participate more fully in the capital markets would be of great benefit to the users of those market. Decentralization of capital markets through allowing greater bank participation would greatly increase the distribution mechanisms available to issuing companies. Many companies that do not issue securities publicly today would probably begin to do so. Also, we probably begin to see the creation of mutual funds of securities of local areas where banks have much greater knowledge and expertise about issuing companies.

Q22. Does the High degree of concentration which currently exists within the investment banking industry and excessive profits earned by those firms, cause any concern that there needs to be greater competition in those markets? Wouldn't banks and other financial services providers be natural entrants in that market? If U.S. banks are prohibited from entering, isn't it more likely that instead of losing market shares to U.S. banks, securities firms will instead lose shares to foreign securities firms and foreign financial intermediaries?

A22. Rather than being competitive, the securities industry is heavily concentrated and virtually controlled by the top ten firms. In 1986, the top ten firms, fewer than 2 percent of all the New York Stock Exchange firms doing a public business, cornered 89 percent of the U.S. corporate debt and equity underwriting market.

The underwriting of mortgage and asset backed securities is even more concentrated. Three of the same ten firms accounted for 69.2 percent of 1986 mortgage and asset backed underwritings. Moreover, five firms underwrite 81 percent of these securities. And the commercial paper market is equally dominated by five of these firms.

The securities market cries out for added competition. competition makes possible lower fees and a wider selection of services and products for consumers. For example, where banks are allowed to compete in the municipal bond market, the spread (or profit) on underwriting is typically a low six to eight-tenths of 1 percent, compared to the corporate securities market, where spreads are commonly in the range of 4 percent.

While entry of bank holding companies in the underwriting market will make the securities markets more competitive, there is no reason to believe banks will dominate. The commercial bank share of the private placement market has never exceeded 10 percent. Banks have not overrun the general obligations market where they have participated for many years. In 1986 the top fifteen managers of general obligation issues included only seven banks accounting for only 27.3 percent of the dollar volume of all the issues managed. Similarly, U.S. commercial banks have not dominated the international securities market despite their active participation as underwriters and distributors in debt and equity securities.

Who will benefit from this added competition? Consumers will be beneficiaries of new services and cost savings that are products of an active, competitive market.

If the competition is not permitted to take place in the U.S., it will occur overseas with resulting loss of jobs and business to U.S. markets.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ROBERT GAISWINKLER

Q.1. On pages 19 and 20 of your written statement, you came out against closing the South Dakota loophole because "the so-called South Dakota loophole language would take the limitations currently embodied in the Bank Holding Company . . . and extend them to bank subsidiaries". That would not be true if the loophole closer was limited to preventing state-chartered banks from exporting services that they are not allowed to conduct in-state. Would you support such a limited loophole closer? If not, why not?

A. Proxmire Q.1. - South Dakota Loophole

The National Council could support the approach to closing the South Dakota loophole which would limit the exercise of state powers to in-state activities. This would not be our first preference since in many markets, particularly New England, banking is already conducted on a regional basis. In addition, there are certain metropolitan areas like the District of Columbia in which state limitations are simply not feasible in terms of conducting business activity. Nevertheless, we feel that the in-state approach is immensely preferable to the South Dakota loophole language advocated by the insurance industry.

Q.2. The U.S. League supports the use of General Accepted Accounting Procedures (GAAP) rather than the Federal Home Loan Bank Board's R41-C regulation governing asset valuations. Does the National Council have a position on this issue? If so, what is that position?

A. Proxmire Q.2. - R41-C

The National Council supports the use of Generally Accepted Accounting Principles (GAAP) by thrift institutions as it relates to R41-C. This would permit, in the case of thrift institutions doing business in economically-distressed areas, a longer period of time in order to work out problem real estate loans.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ROBERT GAISWINKLER

Q. 1. **UnderSecretary Gould characterized as unrealistic the way the U.S. League has calculated the "net income" estimate of the industry for the years 1986-2007 and the calculation of the "shortfall made up by the business." Could you respond to UnderSecretary Gould's remarks?**

A. Garn 1 - **Use of Net Income Method**

Any system for comparing earnings from quarter-to-quarter or on a year-to-year basis is inherently arbitrary. The net income method referred to by Treasury Secretary Gould is an accurate method provided that the comparative data is similarly based. By the same token, for most institutions, operating income also presents an accurate measurement, and for the years in question, namely 1986 to 2007, it is not clear whether these two measurements would substantially diverge.

Q. 2. **Would investors be more likely to buy the bonds issued by the financing corporation under the treasury plan or would they be more likely to buy the bonds issued under the U. S. League plan? Why?**

A. Garn 2 - **Market Acceptance of Bonds**

It is our view that market acceptance of the bonds would not be materially different under either the Treasury plan or the U. S. League plan. The purchasers of these bonds are essentially relying upon the quasi-government status of the obligations for purposes of both interest payments and return on principal.

Q. 3. **One of the main criticisms of the Treasury recapitalization plan is that there is no end in sight to the special assessment that can be levied against FSLIC insured institutions.**

A) Could this criticism be eliminated if there were a provision in the legislation which would specifically phase out the special assessment? Would you support legislation containing such a phase out?

A. Garn 3(A) - **Special Assessment**

The National Council supports specific legislation phasing out the 1/8 of 1 percent per annum special assessment. This is probably the most important feature of the legislation insofar as healthy thrift institutions are concerned, and it would be difficult for the Council to support any bill which does not have firm phase-out language, i.e., not subject to FHLBB override.

B) Some contend that the failure to provide for a phase out of the special assessment would result in a mass exodus of healthy FSLIC insured institutions to such an extent that restrictions would be required to prevent institutions from switching from FSLIC insured institutions to FDIC-insured institutions. How many institutions would actually be able to transfer to the FDIC in light of net worth requirements and other restrictions? Should we consider legislation to prevent such an exodus?

A. Garn 3(B) - Exit Fees

There has been considerable speculation that a large number of institutions would seek to convert from FSLIC to FDIC insurance, but the fact of the matter is that only 25 transactions have been announced over the period of the last two years. The total deposits of these institutions are less than $10 billion as compared to the aggregate amount of FSLIC-insured deposits which is currently in excess of $900 billion. There are many business, tax, financial, and management considerations which weigh heavily in favor of the thrift charter and FSLIC, thus, there is no real need for any language to be incorporated in the FSLIC bill to prevent the flight of healthy institutions to the FDIC.

C) Couldn't this same criticism be levelled against the U. S. League plan since any shortfall in the cashflow needed to finance the debt incurred under this plan would be made up by FSLIC insured institutions? Wouldn't the institutions likely to exist under the Treasury plan be inclined to switch rather than pay?

A. Garn 3(C)

Nevertheless, the National Council takes the position that because of FSLIC current financial stress, it is not unreasonable for institutions to pay some exit fee in order to help alleviate the problem. In our testimony, we have recommended two years of regular premiums plus two years of special premiums.

Q. 4. In his statement before the Committee George D. Gould had a number of criticisms of the U. S. League's plan to recapitalize the FSLIC. These included:

a. A statement that the plan at best provides only $5 billion worth of assistance, and that amount being conditional upon raising it from FSLIC's cash position, not its reserves.

A. Garn 4(A) - Amount of Funding

It has become quite clear that since the recapitalization bill was originally proposed, FSLIC problems are increasing in magnitude. However, we believe that regardless of the size of the problem, FSLIC is simply not prepared to handle funding in excess of $5 - $7 1/2 billion. We therefore support both annual spending limits and full Congressional oversight at the end of two years.

B. A statement that it would be very difficult for the financing corporation to sell 20-year zero coupon bonds in the market due primarily to the vagueness of the repayment sources in the plan. He noted that, "the debt looks speculative at best."

A. Garn 4(B) - Repayment of Bonds

As mentioned in our response to question 2, we believe that the confidence of investors rests primarily in the government backup to these bonds. Therefore, it would not appear to make any difference whether the funds are raised through the sale of zero coupon bonds or more traditional government instruments.

C. A statement that the bond interest rate selected by the League was unrealistically low at 8%.

A. Garn 4(C) - Interest Rates

We support the Treasury position that the authorizing legislation should not include a specific interest rate for the bonds. Pricing should be left to market conditions at the time of issuance.

D. A statement that the plan weakens the bank system by drawing from the FHL banks an annual $275 million or 20% of earnings whichever is larger, for 20 years.

A. Garn 4(D) - Federal Home Loan Banks

There can be no question that the Treasury is correct that its plan is preferable to the U. S. League plan insofar as its impact upon the Federal Home Loan banks is concerned. Both plans utilize the capital of the FHL banks, but the U. S. League plan, which calls for payment of interest by sequestering 20 percent of the banks' annual income, would place an unfair future burden on the banks.

E. And a statement that the plan would raise only 1/3 of the money for over 1/2 of the cost of the treasury plan.

A. Garn 4(E) - Regulatory Costs

We are not qualified to address the question of which plan represents the least expensive means of recapitalizing the FSLIC, and it is our understanding that the investment banking community is divided on this question. In general, we support the mechanics of the Treasury plan which also enjoys greater acceptance among FSLIC-insured institutions, the Federal Home Loan banks, and OMB. However, we do support that portion of the U. S. League plan which calls for Congressional review and annual expenditures limits.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

EUGENE W. KUTHY

Q: Does the Conference of State Bank Supervisors support granting bank holding companies (BHCs) the authority to underwrite and deal in mortgage backed securities?

A: Yes.

Q: CSBS clearly opposes any effort to close the so-called "State Bank Loophole" by applying the limitations of the Bank Holding Company Act to state-chartered subsidiaries of BHCs. How does your organization view the Congress's attempt to close the "South Dakota Loophole" through much less restrictive means, that is, by permitting states to govern the insurance activities of their subsidiaries only so long as these activities are conducted within the state?

A: CSBS would find the approach you suggest, permitting states to govern the insurance activities of state bank subsidiaries within the state only, to be an acceptable alternative to the preemption of state authority over the insurance activities of state banks affiliated with a BHC.

Q: How many states have acted to prevent the chartering of limited purpose banks? Why shoudn't the matter be left to the state?

A: To date, approximately thirty states have acted to prevent the chartering of nonbank banks within their borders. While some of these statutes have been preliminarily upheld by the courts in which they were tested, the legislative approach varies from state to state. Attempts to control nonbank banks may be founded in the state's right to control deposit-taking, to control interstate bank ownership and control, to restrict the non-banking activities of a BHC, to control bank ownership by corporations other than BHCs, or any combination of the above. It may take years to test the correctness of all the variations in the courts, and some state statutes may be found to be insufficient for the purposes intended. In addition, nonbank banks located in states which permit them can cross-market their goods and services across state lines through other corporate offices or through the mails.

Ultimately, the nonbank bank loophole should be closed at the federal level because it is a loophole in the federal laws. Inventive entrepreneurs will seek new ways to utilize its existence even as old ways are closed. Unless massive deregulation of banking is undertaken at the federal level, banks will remain at a competitive disadvantage under federal law. Concentration of economic power and the mixing of commerce and banking through mechanisms unregulated for the harms identified in the Bank Holding Company Act will continue until these matters are addressed.

Q: Would you elaborate on why CSBS opposes that part of the Regulators' Bill that permits unassisted interstate aquisitions?

A: CSBS recommended that the original "Regulators' Bill" be amended both to remove the potential for windfall profit-taking by shareholders in problem banks and to remove the potential for abuse of discretionary authority by strictly defining when a bank is "failing". When the bill was amended to remove the authority for "unassisted" interstate transactions, both of the above concerns were addressed to some degree. The preemption of state statutes in instances where shareholders realize some return would be inconsistent with the "emergency" nature of this legislation, which forms the basis for the preemption.

Q: Should the FDIC assess additional premiums on states who prefer a unit banking structure if the FDIC can demonstrate its resolution costs for failed banks in the state are consistently higher?

A: No. The FDIC insures depositors, not banks or banking systems. There are many public interest considerations which underlie our system of bank regulation. Notwithstanding the current temporary difficulties, scrapping elements of that system solely to save the insurance fund some money would be unsound public policy. Penalizing banks, which have paid into the fund for years, on the basis of the bank structure adopted by their state legislature for historical public policy reasons would be patently unfair.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM GARY E. HUGHES

1. Former Tennessee Insurance Commissioner John C. Neff has stated:

> "Every bank that I know of, sells credit insurance at the maximum price allowed by law and makes no attempt to sell it at a price that would produce a fair return of benefits to consumers."

Do you agree? Can you explain what Commissioner Neff meant when he referred to the failure of banks to "return unearned premiums when loans are paid off or the borrower dies during the term of the loan"?

A.1. Unlike life insurance generally, credit life and credit health insurance rates are strictly regulated in the various states in order to protect the consumer from overcharging. This regulatory system is necessary by virtue of the fact that the creditor, not the debtor, contracts the insurance. This is an important distinction between credit life insurance and other insurance coverages, since the debtor does not negotiate the price or terms of coverage. Nor does the debtor select the amount of insurance. Thus, credit insurance is closely regulated by state law in recognition of the potential for abuse arising out of the relationship between lender and creditor. We believe that Commissioner Neff is correct in stating that banks generally sell credit life insurance at the maximum price allowed by law. This maximum allowable rate is, however, the presumptively reasonable, or prima facie, rate set by the state insurance commissioner on the basis of an assumed loss ratio.

In regulating the price at which credit life may be sold, the states are guided by a statutory standard of reasonableness in relation to the benefits provided under the contract. Since the 1950s when the "reasonableness standard" approach was introduced, insurance regulators have devoted a substantial amount of time to interpreting that language in terms of an expected loss ratio and prima facie rates. In other words, a 50% assumed loss ratio means that $.50 out of each dollar has to be returned to the insured individual in the form of benefits. The balance is used to pay administrative costs, commissions or experience credits to the creditor group policyholder. For credit life insurance, the 50% loss ratio is one which most states seem to recognize; however, the National Association of Insurance Commissioners have recommended, and several states have adopted, minimum loss ratios of 60% or higher. If a prima facie rate of $.55 per hundred of initial insured indebtedness is set on the basis of a 50% loss ratio, then it is assumed that $.275 will be paid out in claims. If actual experience is better or worse than that, the commissioner has authority to raise or lower the prima facie rate as appropriate.

In further refining the credit insurance rate-making process, the regulatory trend has been to lower prima facie rates. These are rates set by the regulators for specified plans of insurance which are assumed to be reasonable in relation to the benefits without support and therefore do not require actuarial evidence on the part of the insurer. The rate-setting process in most states requires public hearing, so consumers, creditors, and insurers have some degree of input.

Your question also refers to a comment by former Commissioner Neff that banks do not "return unearned premiums when loans are paid off or the borrower dies during the term of the loan." We are unable to explain what Commissioner Neff was referring to. It is law in virtually all jurisdictions that a refund must be made of unearned premiums when the loan is prepaid. In case of involuntary prepayment of a debt by proceeds of a life insurance contract, many states provide that there shall be a refund of unearned credit health premiums. Conversely, if a debt is prepaid by the proceeds of a lump sum credit disability contract, there shall be an appropriate refund of credit life premiums. Of course, when the borrower dies and the death benefit provided under the contract is paid, there is typically no unearned life premium similar to other life insurance contracts. This is because the premium rates are set in recognition that a certain number of deaths will occur during the period of time for which premium has been paid. In other words, all of the premium is required to provide the death benefit and there is no provision for an additional death benefit or a return of premium.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
GARY E. HUGHES

Q. 1. What percentage of your members operate insurance companies or distribute insurance products in countries other than the United States? Are any of your members affiliated with banking institutions in any other country? Do other countries, including but not limited to England, Hong Kong, and Japan, permit affiliations between insurance and banking firms? If so, what have been the benefits and costs?

A. 1. As of December 31, 1986, 176 of our 615 U.S. member companies were doing business outside of the United States. This number constitutes 28.5% of our current membership.

We are unaware of any member company having an affiliation with a foreign banking institution. We presume that in the context of this question the term "affiliation" suggests a control relationship.

We are aware that certain countries such as Canada, the United Kingdom, France and Spain allow some affiliation between insurance companies and banking firms. Japan does not. We have no information on the benefits or costs associated with these arrangements.

Q. 2. Will trade in insurance products and services be part of the agenda of the next meeting discussing the general agreement on tariffs and trade?

A. 2. According to information we have received from the U.S.T.R., there will be a discussion item addressing insurance on the agenda of the GATT "Group on Negotiating

Service" at its next meeting to be held at the end of February in Geneva. We expect that there will be more detailed discussions of insurance products in later sessions of the GATT after the Group on Negotiating Service completes its deliberations on the broad question of whether insurance can be brought into the GATT.

Q. 3. How do we define Commerce? Is it simply everything that a bank holding company is not permitted to do?

A. 2. There appears to be little utility in attempting to define the term "commerce", which, as commonly understood, encompasses activities wholly unrelated to banking and other financial products and services. Should you conclude that some type of redefinition is in order, a more manageable approach would be to focus on the term "banking." Indeed, almost all depository institutions are limited by charter to the business of banking and those activities that are incidental or closely related to banking. If a more expansive definition is deemed necessary in this context, you might consider defining "banking and finance" as suggested by Gerald Corrigan of the New York Federal Reserve Bank in his January 1987 essay on the financial services marketplace.

Q. 4. How are insurance rates set at the state level for life insurance? Property and casualty? Health? What are rate bureaus? How do they operate? Who serves on them? How do they interact with the state regulators?

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Garn -- Hughes

A. 4. In no state are life insurance premium rates regulated other than for credit life insurance. Companies do file rate books with the various state insurance departments, and, of course, the reserves on all life insurance policies are strictly regulated by law. However, competition determines the level of premium rates charged by individual companies.

Rate regulation of health insurance is somewhat more complicated, since it depends on the particular statutes and regulations of the individual state. In general, the states have statutory authority to regulate or monitor individual health insurance rates. This is done under some variation of a reasonable in relation to benefits test, and in some states the insurance departments have established loss ratio requirements for various types of individual health insurance products. In the group health insurance area, which constitutes the largest amount of health insurance sold by commercial insurance companies, no state to our knowledge regulates premium rates.

Q. 5. Are any of your members affiliated with an investment company, a securities firm, a nonbank bank, or a finance company? Are those kinds of affiliations common? Is the cross marketing of products ad services a common practice? When are such practices beneficial to all concerned? When do they present a problem? Internally how do your members control such practices?

A. 5. A number of our member companies are affiliated with the entities noted above. As with our response to Question

1, we are assuming that the term "affiliation" connotes a control relationship. The numbers set forth below are, at best, estimates. While we have surveyed our membership in the past to ascertain the extent of some of these relationships, we have not cover them all (e.g., relationships with finance companies) and, in any event, we have not received survey responses from all of our members. The following should, however, provide you with a reasonably accurate picture of the affiliations with which you are concerned.

Investment Companies -- The term "investment company" includes not only conventional mutual funds, but also insurance company separate accounts established to fund variable annuities and variable life insurance contracts. While these contracts are insurance products fully regulated by state insurance authorities, they are also categorized as securities for purposes of the federal securities laws. A life insurance company offering variable annuities or variable life insurance must register its separate account as an investment company under the Investment Company Act of 1940 and must also establish an SEC registered investment adviser and broker/dealer.

Life insurance companies began marketing variable annuity products in the early 1950s and variable life insurance in the mid-1970s. As of December 31, 1986, approximately 151 life insurance companies held assets in separate accounts. Most of these insurers have one or more separate accounts registered as investment companies, although a few may have only unregistered separate accounts used to fund contracts offered in the corporate qualified pension markets. Companies with only unregistered separate accounts would, of course, not have an "investment company" affiliation.

Mutual Fund Complexes -- We are aware of four life insurance companies that have acquired mutual fund complexes.

Securities Firms -- We estimate that there are approximately 30 life insurance companies that have some affiliation with a national or regional brokerage firm. Included within this group are large brokerage firms that have acquired small insurance subsidiaries and large insurers that have acquired brokerages of various sizes. A significant number of these relationships involve insurers that have established subsidiary broker/dealers to engage in various activities. These activities range from minimal sales of tax shelters or limited partnership interests to the provision of full service brokerage.

Nonbank Banks -- Approximately 12 life insurance companies are affiliated with nonbank banks. Several of these limited service banks are nonoperating shells at the present time. In addition, we are aware of 4 life insurance companies that control limited purpose trust companies.

Finance Companies -- We are aware of several life insurance companies that are controlled by finance companies, but have no accurate count of these relationships.

We do not have any information on the extent to which cross-marketing of products and services takes place nor do we have data on the cost/benefits of such arrangements or attendant internal controls.

Q. 6. Do you oppose closing the non-bank bank loophole if the "state bank" loophole is not closed to your satisfaction?

A. 6. We believe that competitive equity requires that the state bank loophole be closed should the nonbank bank loophole be eliminated. From our perspective, the nonbank bank loophole is the avenue by which insurance companies can gain a commercial banking capability. Should that avenue be eliminated, we do not believe it appropriate to permit commercial banks to utilize the state bank loophole to gain broad insurance powers.

This position does not ignore the fact that there are other means for banks to engage in insurance activities (e.g., savings bank life insurance, grandfather provisions and other exceptions to the general prohibition on bank insurance involvement contained in Section 4(c)(8) of the Bank Holding Company Act and the authority of state banks not affiliated with bank holding companies to conduct whatever insurance activity their domiciliary states authorize), or for insurance companies to engage in banking (e.g., ownership of a single thrift institution). However, none of these other means involves the exploitation of loopholes with the consequent frustration of both congressional intent and regulatory authority.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
WILLIAM V. IRONS

Question 1. On page 4 of your written statement, you mention the Comptroller's recent decision to charter 10 new so-called full service banks in the District of Columbia.

Do you think those decisions undermine the Congressional policies underlying the laws that the Comptroller is supposed to administer? If so, explain why.

Answer 1. We believe that the Comptroller's decision to charter so-called "full service" banks in the District of Columbia is erroneous and represents an attempt to undermine long-standing congressional policy. As we understand the Comptroller's decision, approval for the new applications has been based on a District of Columbia statute, D.C. Code 26-101 et seq., that was originally enacted by Congress in 1901 and that has gone largely unused in the 86 years since its passage. Proponents of the "full service" banks argue that the D.C. law permits banks to be chartered in the District of Columbia and to engage in unlimited non-banking activities.

The Comptroller's acceptance of this contention is inconsistent with congressional intent. Congress, through both the National Bank Act and the Bank Holding Company Act, has long insisted that the business of banking be kept separate from commerce. It is inconceivable that Congress, although restricting the non-banking activities of national banking associations and state-chartered banks (insofar as they join bank holding companies) across the nation, desires that banks in the District of Columbia should be treated differently. Rather, the Comptroller's decision to permit the chartering of the D.C. banks is a transparent attempt to evade policies that Congress has long embraced. The Comptroller's action is inconsistent with the proper role of the Executive Branch, which is given the power to enforce--but not to repeal--duly enacted legislation.

Question 2. Your written statement includes an estimate of bank overcharges for credit life insurance totaling $650 million. What is the source of this estimate? What elements of the premium and other fees comprise the "overcharges" you have cited?

Answer 2. The source of our estimate that bank overcharges in connection with the sale of credit insurance have totalled $650 million is the submission (see page three of this document) made to the Federal Reserve Board by John C. Neff in January 1984. The submission was made by Mr. Neff in his capacity as Commissioner of Insurance for the State of Tennessee and as Chairman of the National Association of Insurance Commissions' Credit Insurance Task Force. In his letter, Mr. Neff explains that about 30% of credit insurance premiums are paid out in claims and about 10% go to cover other expenses. Accordingly, about 60% of the premiums represent profit to the banking institution that offers credit insurance. Based on this calculation on "...preliminary information and relating the claims paid in the United States in 1982 to the 60% loss ratio benchmark of the NAIC, it would appear that the consumers in the United States are being overcharged by approximately $650,000,000...." Letter of John C. Neff to William W. Wiles (see page five). Mr. Neff continues by stating that "...I suspect this is a substantial understatement...."

STATE OF TENNESSEE
DEPARTMENT OF COMMERCE AND INSURANCE
114 STATE OFFICE BLDG.
NASHVILLE 37219

JOHN C. NEFF
COMMISSIONER

January 9, 1984

Mr. William W. Wiles, Secretary
Board of Governors
Federal Reserve System
Room B-2223
20th and Constitution Avenue, N.W.
Washington, D. C. 20551

Re: Docket No. R-0491
Elimination of Rate Reduction
Requirements for Credit Life
and Credit Accident and Health
Insurance Underwriting

Gentlemen:

I am pleased to comment to you in regard to the proposed rulemaking described above. I am writing to you not only as Commissioner of Insurance for the State of Tennessee, but also as Chairman of the National Association of Insurance Commissioners' Credit Insurance Task Force which is composed of the commissioners of thirteen states.

You may not be aware of this, but the business of credit insurance in the United States is a national scandal. I know of no other product where the public is so blatantly abused by what are supposed to be responsible financial institutions. Frankly, we are astounded to hear that the Board of Governors is considering permitting bank holding companies to increase the price that they already charge for this product. Every insurance commissioner in the United States has struggled valiantly to try to lower the price of this insurance to a fair level for the consumer. This has been in the face of tremendous opposition by banks and other creditors.

Rather than finding some way to help the banks make more money at the expense of the consumer, it would seem to me that the Federal Reserve Board should be doing what it can to protect the consumer, who may many times be coerced into buying this product. If there is a single reason why the various insurance commissioners are opposed to the banking industry entering the business of the sale and underwriting of insurance, it is credit life insurance. Every bank that I know of sells credit insurance at the maximum price allowed by law and makes no attempt to sell it at a price that would produce a fair return of benefits to consumers.

Mr. William W. Wiles
Washington, D. C. 20551

The National Association of Insurance Commissioners has been engaged in the battle of credit life insurance for many years, and to give you some background on this I am enclosing a recently prepared study of the actions of the NAIC for more than 25 years. In the State of Tennessee I have been trying for five years to reduce the price of credit life insurance and have been fought at every turn by the banks and other creditors. Tennessee citizens buy $51,000,000 of credit insurance and the banks sell just over 50% of this.

In order to give you some idea of the magnitude of this problem, here are some benchmarks. The average insurance company handling homeowners and automobile insurance pays out an average of approximately 65% of its premium dollar in claims. This is what is called a "loss ratio." Health insurers, such as Blue Cross, pay out almost 90% in claims. The average life insurance companies pay out something like 85% in claims, and credit life insurers pay out about 30% when the figures are adjusted to take out credit unions. Credit unions are eliminated because their charge produces a 70% loss ratio and distorts the balance of the numbers.

In other words, credit life insurance pays 30% in claims, about 10% in overall expenses, leaving a 60% profit. In addition, the creditor collects the entire premium for all the years of the loan in advance, giving no discount to the buyer for advance payments. Have you ever heard of anyone paying four or five years of life insurance premiums in advance without a credit? Furthermore, there is no benefit provided for investment income. Finally, the refund policy is so slanted in favor of the lender that the poor borrower gets almost nothing back.

Those of us in the National Association of Insurance Commissioners have been wondering why the Federal Reserve Board permits this to continue. Rather than trying to figure out some way to raise the price, you should be working on a way to reform the business.

In the hope that you might be interested, I am also enclosing a memorandum that I wrote to the members of the General Assembly of the State of Tennessee reporting on the sale of credit insurance. It will not take you long to see what I am talking about when you look at the relation of benefits paid to premiums collected. In Tennessee there is a 40% commission cap paid by the insurance company to lenders who produce the business, but even this apparently is not enough. The business is so profitable that lenders have organized wholly owned reinsurance companies in Arizona to capture the balance of the profits. Almost every bank holding company in the State of Tennessee owns a credit reinsurer which is permitted by the Federal Reserve Board to enable them to participate even more in this outrage.

Mr. William W. Wiles
Washington, D. C. 20551

The shame of all of this is that credit insurance is a useful social product and one that should be available to consumers at a reasonable price. The commissioners across the United States would like to be in a position to recommend that the consumer buy this product for his safety and protection in the event of death or accident. It is very comforting for a widow to know she does not have to make the next car payment in the event of the death of her husband. Instead we are forced, because of the price situation, to recommend against purchasing this product.

One final comment, the National Association of Insurance Commissioners, through its task force, has been attempting to gather data on this subject on a national basis. Based on our preliminary information and relating the claims paid in the United States in 1982 to the 60% loss ratio benchmark of the NAIC, it would appear that the consumers in the United States are being overcharged by approximately $650,000,000, and I suspect this is a substantial understatement. Of this, more than 50% is going to the banks and apparently the board wishes them to make even more.

I would, of course, be pleased to discuss this matter further with you or any members of the board, should you find this desirable.

Sincerely yours,

John C. Neff
Commissioner and
Chairman, NAIC Credit Insurance
Task Force

JCN:daw

Enclosures

cc: Mr. Robert H. Myers, Jr., Esquire
Mr. Paul Volcker, Board of Governors
Ms. Nancy Teeters, Board of Governors
Commissioner Bruce Foudree, Iowa
Commissioner Bill Gunter, Florida
Members of the NAIC Credit Insurance Task Force
Mr. E. Benjamin Nelson, Executive Vice President, NAIC
Ms. Sandra L. Wagner, Esquire

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM WILLIAM V. IRONS

NACSA
NATIONAL ASSOCIATION of
CASUALTY & SURETY AGENTS
Government Affairs Office
Joan Albert Dreux
Executive Director

February 25, 1987

The Honorable William Proxmire
Chairman, Committee on Banking,
Housing and Urban Affairs
534 Senate Dirksen Office Building
Washington, D.C. 20510

Re: Questions #1 and #2 From Senator Garn to William V. Irons, Insurance Agent Coalition Witness, January 23, 1987

Dear Mr. Chairman:

On behalf of the Insurance Agent Coalition witness, William V. Irons, I submit the following letter and its attachments to the Senate Banking, Housing and Urban Affairs Committee for the hearing record of the January 23, 1987, hearing in response to written Questions #1 and #2 submitted to Mr. Irons by Senator Jake Garn. Mr. Irons and the Insurance Agent Coalition thank the Chairman for a week's extension to respond to the technical questions asked by Senator Garn.

In response to Question #1, "How do we define Commerce? Is it simply everything that a bank holding company is not permitted to do?", I refer you to Attachment I which reviews in detail the insurance agents' current and historic perspective on the term "commerce", as distinct from the term "banking".

In response to Question #2, "How are insurance rates set at the state level for life insurance? Property and Casualty? Health? What are rate bureaus? How do they operate? Who serves on them? How do they interact with the state regulations?", please find below a general explanation of insurance ratemaking, and Attachment II, made up of two exerpts from insurance journals[1] explaining the insurance ratemaking process and the role of rating organizations, along with a copy of testimony presented before the House Judiciary Committee's Subcommittee on Monopolies and Commercial Law by Mavis A. Walters, Senior Vice President of the Insurance Services Office, Inc., on September 13, 1984. The Insurance Services Office, Inc., (ISO) is the largest Property/Casualty (P/C) insurance statistical agent, advisory organization and/or rating or a rate services organization. The information contained in this letter is generally

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[1] "The General Rating Process," Insights into Life, Health, Home, Auto and Commercial Insurance, (Northbrook, Illinois: Allstate Insurance Group, 1985), pp. 189-194 and "The Ratemaking Process," Sharing the Risk - How the Nation's Businesses, Homes and Autos are Insured, (New York: Insurance Institute, 1981), pp. 109-113.

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applicable to the P/C insurance business rather than to the life and health insurance industries. In the life and health insurance business, for example, rating bureaus are not used. In life insurance, rates are set by individual companies, using as one guideline, mortality tables. In health, most insurance is available on a group basis through an employer. Group insurance is priced on the basis of types of benefits offered, of group experience, i.e., experience rating, and of the projected cost of providing these benefits.

Thus, in a little more detail, P/C ratemaking is different from life and health, and its use of rating bureaus is unique due to the unique nature of the P/C business. Insurance rates or rate levels for almost all lines of P/C insurance including passenger auto, homeowners, commercial auto or the general liability sublines are determined on a state-by-state basis by reviewing the loss experience in that state for each of the lines and coverages. In addition, there are usually territorial distinctions made within a state so that different geographical areas such as major cities and towns and rural areas will have different applicable rates based upon their relative loss experience compared with the state-wide average. Product liability rates, however, are made on the basis of countrywide experience because of the necessity for a countrywide data base for statistical credibility and because of the obvious ability to transport and use products all over the country.

Classification relativities, on the other hand, i.e., the relationship between and among different rate classes, are determined on the basis of countrywide data. This means, for example, that while the rate relationship between grocery stores and hardware stores would be the same in South Dakota as in, say, Pennsylvania, the rates for both types of stores in South Dakota are probably well below the rates for those stores in Pennsylvania.

It should also be recognized that the prices or premiums charged in the marketplace can, and often do, vary significantly from the rates as developed and distributed by an advisory rate organization such as ISO, or even rates filed by an independent insurer. Insurers frequently deviate from ISO rate levels, (most often down, not up), and have independent programs particularly for package policies which are independently priced. In addition, the use of experience and schedule rating programs provides a great deal of flexibility to the underwriter in his assessment of the underlying exposure and appropriate prices to charge each individual risk. In some instances the actual incurred losses for a particular risk may be sued, to the extent credible, in the individual risk rating programs. However, the absence of a claims history does not indicate that claims will not occur in the future. This is one of the reasons that insurance is purchased, since no one can predict with certainty if and when claims will be incurred for any individual risk.

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Finally, competitive strategies, marketing considerations, growth and market share priorities and other factors can influence an individual insurer's perspective or judgment regarding the appropriate price to quote for a risk.

The Insurance Agent Coalition trusts this letter and its attachments adequately responds to Questions #1 and #2. If a more detailed response to the ratemaking process is desired, it might be helpful to the committee to directly solicit such views from representatives of rating bureaus and insurance underwriters who are directly involved in the business of determining rates.

Respectively submitted by,

Joan Albert Dreux

Joan Albert Dreux
Executive Director
Government Affairs

JAD/mbm
Attachments
cc: Richard C. Carnell

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Garn -- Irons

ATTACHMENT I

DEFINITION OF COMMERCE

During the testimony of a panel of representatives of insurance agent associations before the Senate Banking Committee on January 23, 1987, you requested that the insurance agent associations provide you with a definition of the term "commerce."

Since its inception, the Bank Holding Company Act of 1956 ("BHC Act") has contemplated that "banking" and "commerce" remain separate. As a consequence, the definition given to the term "commerce" is extremely important for purposes of interpreting the BHC Act. Moreover, given the reality of a dynamic economy, the terms "banking" and "commerce" must be viewed with some level of flexibility.

As is often the case with terms which are invested with profound statutory and economic significance, it is sometimes necessary to provide definitions which describe what those terms exclude rather than what they include. Congress has already ably defined the term "banking" in Section 24 of

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Garn -- Irons

the National Bank Act. 12 U.S.C. § 24 (1982). The National Bank Act is the flagship statute which articulates the center of gravity for banking policy at the federal level. All other federal banking statutes, in essence, embellish the themes already set forth in the National Bank Act. Those other statutes were crafted to address discrete developments in the federal banking system, such as federal deposit insurance, bank service corporations, establishment of the federal reserve system, and regulation of bank holding companies.

In order to ensure that the economic policies reflected in the BHC Act remain consistent with those originally developed in the National Bank Act, "commerce," within the context of the BHC Act, must be defined as including all activities which are not defined as banking under the National Bank Act. That definition would also be entirely consistent with the long-standing, well-reasoned, and logical predicate which underlies the BHC Act. Under such an interpretation of the term "commerce," banking institutions would remain capable of engaging in a broader range of activities than are included within the definition of banking under the National Bank Act. They would be allowed to do so, however, only by satisfying one or more of the exceptions contained in Section 4 of the BHC Act which permit bank holding companies to engage in a limited number of nonbanking activities provided the requirements of those specific exceptions are met.

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Garn -- Irons

ATTACHMENT II
A

SHARING THE RISK

How the Nation's Businesses, Homes and Autos Are Insured

JAMES R. MARKS
Project Director

JOHN D. CRAIGIE
Vice President-Publications

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Garn -- Irons

THE RATEMAKING PROCESS

Where early-day insurers were forced to rely largely on judgment in deciding how much to charge for the coverages they offered, today's highly advanced professionals have the benefit of years of experience upon which to draw in the development of rate structures which reflect varying degrees of risks—or the loss potential—of the many persons or interests they are called upon to insure.

In fire insurance, for example, it is recognized that the likelihood of a "fire-resistive" factory being destroyed by flames is less than the chance of a wooden factory burning down. In automobile insurance, persons who regularly drive their cars to work through rush-hour traffic are exposed to greater hazards than persons who drive only occasionally for pleasure in the same city or community.

RATING FACTORS

CLAIM FREQUENCY, SEVERITY

For the major lines of property/casualty insurance, the rates vary from state to state and even from community to community depending on the accident record of local motorists, the extent of fire protection available for property owners, the prevalence of crime and other factors. But while many such factors are considered in ratemaking, rates basically are dependent on two primary factors:

- the frequency of claims (which generally parallels the frequency of such occurrences as auto accidents, fires and thefts).
- the severity, as measured by the cost, of each claim (which in turn is affected by the costs of goods and services for which insurance pays).

In their periodic review of rates, companies use this "loss experience," supplemented by factors reflecting economic trends, as a guide to the amount they will be required to pay for future claims, to meet the costs of doing business (including taxes) and to realize a profit.

It's a complex process. Insurance can't be priced like most products, since the money people pay for it is intended to help cover the cost of unforeseen future happenings—a fire, for example, or an auto accident, or a burglary. Since premiums are paid in advance, the price must be determined before the actual loss costs are known.

ACTUARIAL FUNCTION

Thus, ratemaking is a task which requires special, highly developed skills and training. The insurance specialist responsible for the ratemaking function, known as an actuary, must be at the same time an analyst, an expert mathematician and a predicter of what is likely to happen in the future. The actuary bases his or her predictions on past experience and available information which can be taken as a reliable indicator of future trends.

For example, insurance industry studies indicate that small cars (compacts and subcompacts) are involved in more accidents, on the average, than larger models and that the frequency of personal injury claims is higher among occupants of the smaller vehicles. This suggests that as long as the popularity of small cars continues, auto insurers face the prospect of a worsening loss experience. The situation could improve, however, if the number of big cars on the highways were to decline significantly.

Another factor that ratemakers must take into account is that in some lines of insurance, such as workers' compensation and liability insurance, losses (or claims) often are paid many years after the premium is calculated and the policy is sold.

In short, the actuary must analyze the experience and the outlook for each line of insurance in terms of claims which already have been paid, outstanding losses—some of which may take several years to settle—and even unreported losses which experience says eventually will find their way into the claims files.

RATEMAKING APPROACHES

There are several categories of ratemaking:

Class Rating

In this most frequently used form of ratemaking, large segments of the population with generally similar expectations of having a loss are grouped into separate classes—or classifications—and assigned separate rates reflecting their average degree of risk. The classification system under which car owners customarily are divided into several categories for rating purposes (see page 16) is a prime example.

**RATES/
PREMIUMS**

In this connection, it is important that a clear distinction be made between insurance rates and insurance premiums. A premium is the amount a policyholder pays for a policy, while a rate is the pricing factor on which any given unit of the premium is based. For example, a car owner usually pays his or her insurance company a single premium. But the policy probably will include both bodily injury and property damage liability coverages along with such other elements as collision and comprehensive fire and theft coverages. The total premium is based on separate rates for each of those units, in most states taking into account the policyholder's age, sex and marital status. The premium is subject further to any discounts or surcharges which might apply—a driver's education discount, for example, or a surcharge resulting from a poor driving record.

**MANUAL
RATING**

These class rates are published in manuals which are used daily, as a basis for determining the proper price of a policy, by persons involved in selling insurance. For the most part, rating by manual applies to insurance for individuals and small businesses.

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Garn -- Irons

Judgment Rating

Some insurance categories—ocean marine in particular—do not lend themselves to class rating because of a lack of similarity among individual risks or a lack of sufficient credible statistics. In such cases, both the acceptability of the applicant for coverage and the rate at which the policy will be written is left to the judgment of the underwriter.

Experience Rating

This involves developing a future rate for an insured by modifying the manual rate to reflect the policyholder's actual experience over a period of several years. A form of experience rating with which many car owners are familiar is the surcharge which some companies add to the auto insurance premium of motorists who are held to be responsible for accidents.

Retrospective Rating

Like experience rating, this is a form of merit rating in that it is used as an incentive to encourage safety. It frequently is applied to liability and workers' compensation premiums for large firms, as well as to commercial automobile, product liability and contractors' liability premiums. Under this procedure, an experience rated premium is adjusted at the end of a policy period in accordance with the insured's actual experience.

RATING ORGANIZATIONS

Accuracy in ratemaking is heavily dependent on the availability of the largest possible body of statistics which collectively make up loss experience. Most companies, the smaller ones in particular, normally do not have enough such data of their own to develop statistically sound rates which they could support as being reasonable and neither too high nor too low.

Therefore, for many years property/casualty insurance companies have supported a number of rating organizations which not only use the combined data of their affiliates to develop rates and rating systems, but provide other related services including the creation of standard insurance policies and policy forms.

NATIONAL ORGANIZATIONS

The largest such organization is the Insurance Services Office (ISO), which operates countrywide and computes rates for most major lines of property and casualty insurance. In most states, ISO files advisory rates which members and subscribers may use as filed or as a basis for "deviations" supported by their own experience. In some cases, ISO files rate changes on behalf of member companies, or provides statistical and actuarial data to companies which want to file their own rates.

Another rating and rate advisory organization for personal and commercial lines of insurance is the American Association of Insurance Services, whose membership is comprised principally of small and medium size companies.

SPECIALTY ORGANIZATIONS

The insurance industry also supports a number of specialized rating organizations. The National Council on Compensation Insurance administers rating plans and systems for workers' compensation insurance in most states (state rating organizations perform similar functions in other states). The Surety Association of America establishes fidelity and surety rates and makes rate filings on behalf of members which authorize it to do so. The Crop-Hail Insurance Actuarial Association is a national rating organization and statistical agency for the fields of crop-hail and rain insurance. The Nuclear Insurance Rating Bureau develops rates for insurance to cover properties of nuclear installations.

The Automobile Insurance Plans Service Office serves as a rating organization and/or statistical agent for the automobile (assigned risk) plans in most states.

STATE RATING BUREAUS

A state counterpart of the national rating organizations is the North Carolina Rate Bureau, of which all insurers which sell automobile, homeowners or workers' compensation insurance in the state must be members. On behalf of its members, the bureau files applications for rate changes applicable to those kinds of insurance, subject to the approval or other action of the insurance department.

State rating bureaus perform special functions in Massachusetts and Texas, where rates for certain kinds of insurance are set by state regulatory agencies. The Massachusetts Automobile Insurance Rating Bureau is a statistical organization whose recommendations are considered by the state insurance department in setting auto insurance rates for use in that state.

In Texas, rates for both automobile and property insurance are set by the State Board of Insurance. The board is guided by recommendations of the Texas Automobile Insurance Service Office (for auto insurance) and the Texas Insurance Advisory Association (for property insurance).

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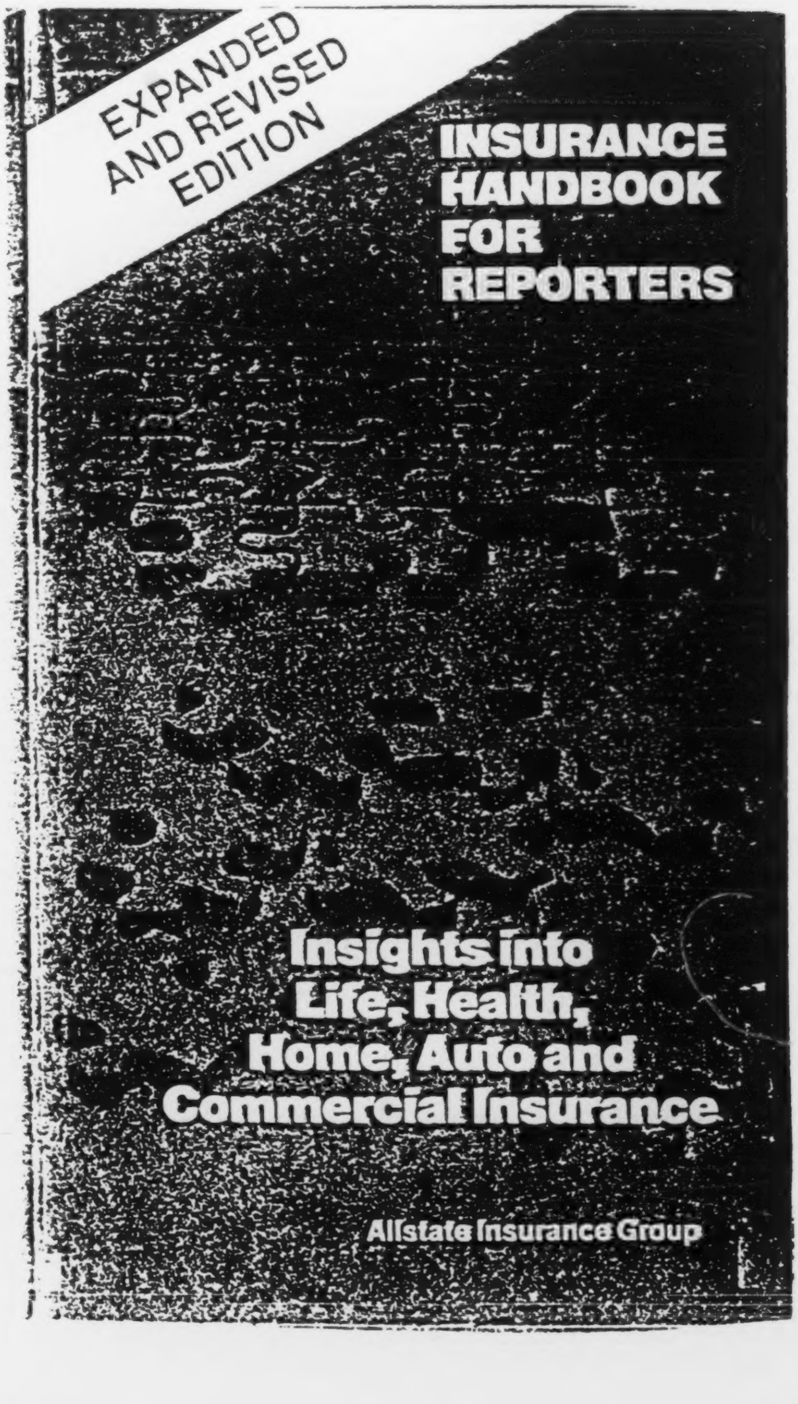
ATTACHMENT Ii

B



EXPANDED AND REVISED EDITION

INSURANCE HANDBOOK FOR REPORTERS

Insights into Life, Health, Home, Auto and Commercial Insurance

Allstate Insurance Group

The General Rating Process

The fundamental basis for the development of rates in a particular line of insurance is the estimate of losses or payments of claims for the varying risks being insured in that line during future months, and a determination whether current rates are adequate or inadequate to pay these losses.

These estimates used in calculating the rates or premiums to be charged are made by insurance actuaries, highly skilled technicians who base their projections on many factors. Very important is their analytical examination of a company's own loss experience in the specific coverage being priced. This loss experience is measured by two primary factors:

> *Claim frequency,* usually expressed as the number of claims occurring per 100 insured units or exposures under a particular coverage during one year. (For example, if auto collision coverage claims occurred at the rate of 10 for every 100 cars insured for collision for one year, the frequency would be 10 percent.)
>
> *Claim severity,* or the average cost of each claim paid under a particular coverage. As indicated in the introduction to this chapter, inflation has continued to escalate the average cost, or severity, of claims in all lines for decades.

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ATTACHMENT II
C

STATEMENT OF
MAVIS A. WALTERS
SENIOR VICE PRESIDENT
INSURANCE SERVICES OFFICE, INC.

SEPTEMBER 13, 1984
SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW
OF THE
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

Insurance Services Office, Inc. (ISO) is a non-profit corporation serving property-casualty insurance companies in all fifty states, the District of Columbia and Puerto Rico. Typically, we are authorized to operate as a statistical agent, advisory organization and/or rating or a rate service organization.

ISO was formed as a voluntary association of property-casualty insurance companies in 1971 through the consolidation of many separate national, regional, and state service organizations or bureaus. It incorporated in 1982. Although ISO today performs many of the essential functions of the predecessor organizations, it operates in a manner so different from that of its historical antecedents that the term "bureau" is no longer appropriate. ISO has no mandatory membership requirements, nor do we have adherence requirements with respect to advisory rates, loss costs, policy forms or programs. In fact, we actively encourage independent action by participating insurance companies.

ISO's primary mission is to serve participating insurers by gathering, storing and disseminating statistical information to regulators--as required by law--and to insurers for their own use. We also develop and assist in implementing programs that help define and cover risk; and finally, we promulgate advisory rates or advisory prospective loss costs for sixteen different lines of insurance in the various jurisdictions.

Some of the specific services offered by ISO are as follows: We develop programs and coverage documents for possible use by insurers. These programs are designed to meet the minimum coverage requirements of the insurance marketplace. By drafting standardized documents we provide insurers with basic tools to help them define, price and deliver coverage economically.

We serve as a statistical agent which involves the development of statistical plans and the collection and compilation of statistical data from participating companies. The aggregate data are submitted to regulatory authorities, thereby fulfilling state requirements and providing statistics in a common format for regulatory use and review.

We also perform actuarial services which involve the preparation, review and analysis of statistical data to develop reasonable projections of rate level need, overall, by class and by territory. This results in either advisory rates or advisory prospective loss costs, which may or may not be filed with regulatory authorities in different jurisdictions depending upon the type of rating law or regulatory requirements. This information is also provided to participating insurers, each of whom may elect to use, modify or disregard that information depending upon their own needs or requirements.

Our wholly-owned, non-profit subsidiary, ISO Commercial Risk Serivces, Inc., conducts commercial property insurance rating surveys throughout most of the country to help establish specific building rates for fire insurance and other property coverages. The reports which are issued from these surveys give insurers a better picture of the rating conditions at the buildings they cover and therefore help individual insurers rate their risks more accurately.

We believe it is important that this Committee appreciate the role that ISO plays in the property-casualty insurance industry today as contrasted with the historical view of "rating bureaus". Thirty years ago these bureaus were organized along local, regional and national lines. They specialized in either property or casualty insurance, for one or more lines of coverage. Collectively these bureaus came to be regarded as an insurance cartel. They were

In addition to this loss experience, insurers analyze other recent trends affecting various aspects of the coverage, to project future claims and operating costs as the basis for determining the need for any rate changes that may be required to pay for them.

Other Factors in Rate Making or Pricing

Rates for the major lines of property/casualty insurance vary from state to state and among a number of rating "territories" or "zones" within each state in most instances.

Typically, these variations by territory reflect differences in loss experience among the territories for the particular insurance coverages. But numerous additional factors, which may affect the future loss potential of a risk, and which vary depending on the nature of the coverage, affect rate making.

Types of Rate Making

The basic rate-making methods can be categorized as follows:

Class Rating. This type of rating is used to group policyholders or properties sharing the same general characteristics into separate classes (with separate rates) according to their differences in exposure to loss. As will be seen in this chapter's detailed description of how class rating—or classification—is applied to private-passenger automobile insurance rate making, this system makes it possible to distribute the cost of insurance equitably among policyholders in each classification. Most rate making today uses class rating as a basis. It is also widely used in other personal-lines insurance, including homeowners, fire, health and in a number of commercial lines, including multiple-line package policies and workers' compensation insurance, particularly for smaller businesses.

Judgment Rating. In some lines of insurance, credible loss statistics are not available or loss exposures of individual risks are so diverse that class rating is not feasible. This is largely true in some lines of inland marine insurance. In these cases, it is left to the underwriter's judgment to evaluate each applicant and determine the rate.

Merit Rating. This involves the adjustment of rates up or down based on individual loss experience. There are several types of merit rating plans including:

Experience Rating. Its most distinctive characteristic is that the insured's past loss experience, typically over a period of several years, is used to modify the class rate for the next policy period. For example, many auto insurers surcharge drivers for "chargeable" accidents or moving traffic violations, or lower rates following accident- and violation-free periods. Experience rating also is frequently used in insuring larger businesses that generate sufficiently credible experience, in such lines as general liability, workers' compensation, various other commercial lines, and group health insurance.

Retrospective Rating allows adjustment of a commercial insured's final premium for a current policy period based on the insured's own loss experience during that period. It is widely used in workers' compensation, general liability and commercial auto liability and physical damage insurance.

Schedule Rating, widely used in fire insurance for most larger commercial properties and businesses, individually rates each risk by a system or "schedule" designed to measure differences in relative quantity of fire hazards among risks, and their influence on the insured's future loss potential. Credits or debits, based on maintenance of a building and premises, location and accessibility, and other factors, are figured into the schedule rate. It encourages reduction of hazards which could lead to losses. Schedule rating also is used in commercial multi-peril policies, commercial auto, and in some states for workers' compensation.

Rate-Making Differences Among Companies

Rate-making methods for the property/casualty insurance lines differ from company to company, depending on the individual firm, the size of its statistical base in individual lines, and state laws. Where permitted by statute to do so, large insurance companies generally perform their own actuarial analysis in their major lines, but smaller companies may not have sufficient data to do this reliably. Consequently, they generally depend on rating organizations or "rating bureaus," which collect statistics from many cooperating companies and recommend rate plans for their members based on this data. Larger companies, which do not write big volumes in some lines, also frequently base rates on bureau rates in those lines. Some companies use bureau rates, others use *deviated rates*, by which the bureau rate may be discounted. In a few states, bureau membership or rates prescribed by a state agency are mandatory; however, deviations may be permitted.

Usually, bureaus and individual companies review rates at least once a year in each state for major lines. In times of sharp inflation, however, rate reviews may be instituted more often. Rates are changed only when there is sufficient justification supporting the need for a rate-level change.

Competitive considerations, regulatory pressures, and other factors often cause insurance companies to implement a lower-rate level than the statistics indicate.

Rate Supervision By States

Most major kinds of insurance, including property and casualty lines, are subject to some degree of rate supervision by the individual state's insurance regulatory agency, which has primary responsibility for insurance regulation in each state. All states have some types of insurance regulation. Most states review rate changes in the property/casualty lines and other states have provisions for monitoring changes in accord with the individual state's system of rate supervision. (For other aspects of the states' regulatory functions, see *Regulation* in chapter, "How Insurance Serves.")

Four systems of rate supervision for property and casualty (liability) insurance, including personal lines (such as auto and homeowners), and commercial lines, are reflected in the various state laws:

Prior approval, under which rate change proposals must be filed with and approved by the state before they can be put into effect.

File and use, where companies file notice of rate changes and the state reserves the right to review the new rates later.

Use and file, in which companies may implement a rate change and afterwards file a notice of the rate revision.

Open or competitive rating, which allows companies to introduce new rates as needed, on the theory that the marketplace will serve as a rate regulator. Under this system, the regulatory agency would intervene only in instances where a company has violated the insurance rating laws of that state.

Additionally, one state (Illinois) does not have a rating law, but regulates the insurance marketplace through a state anti-trust law and indirect supervision of rating activities in most property and casualty lines. Studies have indicated this has resulted in a competitive environment benefiting both insurers and consumers.

Rate revisions may be filed with state insurance departments by individual companies or by rating organizations on behalf of groups of insurance companies. Filings are generally accompanied by statistical data supporting the changes, but the filer also may utilize informed judgment in the absence of sufficient statistical data. The state insurance commissioner or director then evaluates the revisions on the basis of at least these three criteria:

> Are rate schedules sufficient to keep the company solvent and cover its probable losses?
>
> Are the rates free of unfair discrimination?
>
> Are the rates excessive?

(It is important to note the term "unfair discrimination." Insurance classification systems by their nature discriminate among the possible risks to be insured. For example, houses made of frame are distinguished from those made of brick, and separate rates are charged for each group. The variation in rates relates directly to the nature of the risk. Thus the requirement that rates cannot be unfairly discriminatory is a term of legal and regulatory definition generally requiring that classification systems be statistically supportable and uniformly applied.)

If in the commissioner's judgment the rates fall within what has been called a "zone of reasonableness," the commissioner may allow the rates to go into effect as filed. Or, if the rates do not meet with the commissioner's approval, then he or she may ask for revisions of the rate schedule.

Any company that is legally affected by the approval or disapproval order may request a hearing on the regulator's order. The evidence produced at the hearing must support the reasonableness of the commissioner's order. A further appeal through the state's court system is thereafter available to a party dissatisfied with the result of the hearing process.

characterized by mandatory membership requirements, complete adherence to rates, rules and forms and full indivisible services. If a company was affiliated for one service it was affiliated for all of them. An affiliated insurer was required to use and to adhere to bureau programs and rates.

Those days are long gone. Indeed, the monolithic cartel had already virtually disappeared by the time Insurance Services Office was formed in 1971. From its inception, ISO has encouraged individual insurers to make their own rate level decisions. Significant changes in the regulation of insurance pricing have been occurring for over twenty years. Over half the states have joined California in turning away from strict prior approval rate regulation and in adopting less administerial forms of price regulation, at least for some lines of insurance. And the trend is continuing.

While these changes in the regulation of insurance pricing were evolving, the traditional bureaus were transformed into a modern advisory rating organization which can perform many necessary services more efficiently than individual firms. Indeed, in today's competitive environment, insurers will only participate in a rate service organization under two conditions: (1) where that organization performs functions which can best be performed collectively and (2) where economies of scale in certain collective activities enhance rather than diminish competition. This is why we view ISO's essential task to be the development of information which will assist participating insurers in the making of informed, intelligent and independent pricing decisions.

To that end it is ISO's corporate policy, endorsed by the ISO Board of Directors, that for private passenger auto and homeowners insurance, in competitive type rate regulatory states, ISO will:

- promulgate and distribute to insurers prospective loss costs only,
- separately provide insurers with aggregate expense data,
- develop the rate-related information without any insurer committee involvement.
- not develop any final advisory rates.

By providing only prospective loss costs for private passenger auto and homeowners insurance in competitive type regulatory states ISO further encourages independent pricing while continuing to provide essential information to insurers to aid them in making intelligent and informed pricing decisions.

Of the three components of a final advisory rate, the prospective loss cost is the single most important product which a centralized, company-supported rating and advisory organization must continue to develop and distribute to insurers. Based on aggregate insurer data, the prospective average loss cost provides essential information in determining both overall rate adequacy needs and actuarial equity between various risk classifications. It is particularly valuable because it is developed from a credible and reliable data base, which no single insurer can replicate for all lines of insurance.

It is this point, more than any other, which this committee should understand. A distinguishing characteristic of insurance is that the cost of the product is not known until long after the product has been sold. Yet the price must be determined before the time of sale. Unlike most other businesses, the insurance business cannot base its prices on the known cost of materials, labor, equipment, or operations. Instead, insurers must base their rates on anticipated and estimated future losses (claims ultimately paid and related costs). Such estimates in turn are based on historical data gathered for insurance policies written in the past and claims paid or incurred on those policies.

Indeed, an entire profession, the casualty actuarial profession, has evolved and developed to find technical analytical solutions to the problem of determining prices before the costs are known. A popular definition of an actuary is a professional who is trained in evaluating the current financial implications of future contingent events.

Central to the process of ratemaking is the data base from which the future costs must be estimated. With a broad aggregate data base the actuarial analysis of expected losses is more reliable. ISO's large data base improves credibility thereby increasing confidence that the prediction of future costs is an accurate one. With confidence in the calculations of future costs, insurers need to seek less of an overall profit margin in the prices they charge their insureds. In addition, to the extent that ISO's economies of scale reduce the cost of many necessary insurance company functions, insurance consumers reap the benefit.

We believe that the services provided by ISO are important to insurers in their own ratemaking and pricing activities and are conducive to increased competition. The aggregation of data into classification detail requires not only a countrywide data base of many insurers but also special technical expertise and experience. With a centralized service organization providing these products and services, smaller and medium sized firms are able to compete and operate more efficiently and effectively. These services also provide certain economies even to larger insurers, permitting them to enter into new product lines and markets.

By improving insurers' knowledge of their true costs and by introducing economies of scale, ISO confers benefits to the insuring public through lower costs. According to many, the repeal or substantial modification of the McCarran-Ferguson Act would cast a pall of uncertainty over the legitimate and useful functions of rating organizations and thereby impair the benefits which the insuring public derives from them.

Over the years various commentators have speculated on the impact of the repeal of the McCarran-Ferguson Act. They have identified many functions of rating organizations which some might claim to be violations of federal antitrust laws. Among those functions are:

- The collection, combination and distribution of data.
- The collective development of policy forms.
- The development and filing of rate structures, rates and rating plans.
- The surveying and classification of risks.

ISO's operations ultimately benefit the insuring public as well as many small insurance companies. The pall that would be cast over these essential operations by the repeal or substantial modification of McCarran-Ferguson could be enough to severely curtail them. The result would be a disservice not only to insurers, large and small, but to the insuring public as a whole.

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Answer to Remaining Question from The Honorable Jake Garn
Vice Chairman, Committee on Banking, Housing, and Urban Affairs
From
William V. Irons, CLU
Chairman, Financial Institutions Task Force
National Association of Life Underwriters

Question 3. For each Association in your coalition, is it common (or is it becoming more common) for an agent or an agency to offer its customers a full line of insurance products from property to life and health? Are more agents beginning to offer mutual funds? CD's? Financial planning?

Answer 3. To the best of my knowledge approximately 25% of the approximately 135,000 individual members of NALU's state and local associations offer property/casualty coverage in addition to life and health insurance.

The National Association of Life Underwriters sponsors a professional liability policy for life insurance agents. A separate rider is available for those who engage in financial planning. Approximately 1.25% of NALU's entire membership has applied and received this financial planning insurance coverage.

As far as I can ascertain, less than 1% of NALU's entire membership offers mutual funds to their customers.

To my knowledge, Certificates of Deposit are not offered by any of the 135,000 members of NALU's state and local associations to their customers.

NACSA
NATIONAL ASSOCIATION of
CASUALTY & SURETY AGENTS

Government Affairs Office

Joan Albert Dreux
Executive Director

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Garn -- Irons

February 20, 1987

The Honorable William Proxmire
Chairman, Committee on Banking,
Housing and Urban Affairs
534 Senate Dirksen Office Building
Washington, D C 20510

Re. Question #3 From Senator Garn to William V Irons,
Insurance Agent Coalition Witness, January 23, 1987

Dear Mr Chairman

On behalf of the National Association of Casualty and Surety Agents (NACSA), an association representing some 300 of the nation's leading property/casualty insurance agencies and brokerage firms, I would like to respond for the record of the January 23, 1987, hearing of the Senate Banking, Housing and Urban Affairs Committee to Question #3 of Senator Garn's written questions to the insurance agents' witness, William V Irons.

In general, your larger sized insurance agency and brokerage firm will offer a full line of insurance products - property/casualty, life and health. Additionally, larger firms often provide risk management services to buyers. In the area of employee benefits, for example, agents will help design employer benefit plans by securing traditional insurance products and by designing and putting into place non-traditional insurance mechanisms such as self-insurance funds or captives. It would be unusual for a very small agency to offer such sophisticated insurance services. However, there are agencies which have as their particular area of expertise these types of services and as a smaller agency, they would then concentrate in that specialty service.

The vast majority of agencies have not crossed over into other types of financial services which you mentioned - mutual funds, CD's, and financial planning. Insurance products and their directly related insurance services continue to be their focus and desired expertise. Insurance agencies may be involved in financial planning in so far as securing insurance and designing non-traditional alternatives is a part of financial planning. As a general rule, you will find banking and securities products and services have not become a part of the product line offered by independent insurance agencies and brokerage firms.

I trust this answers Senator Garn's question adequately. If not, please feel free to contact me.

Sincerely,

Joan Albert Dreux

Joan Albert Dreux
Executive Director
Government Affairs

600 Pennsylvania Avenue, S.E.
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Washington, D.C. 20003
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Casualty/Surety/Fire/Marine
Founded in 1913

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PROFESSIONAL INSURANCE AGENTS
400 N. WASHINGTON ST. • ALEXANDRIA, VA. 22314 • (703) 836-9340

February 24, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Mr. Chairman:

This is in response to your letter of February 6 to William V. Irons, the witness for the Insurance Producer Coalition on January 23rd, requesting answers to a series of questions posed by the Chairman and Senator Garn.

The following are answers by the National Association of Professional Insurance Agents (PIA) to the 3rd question(s) from Senator Garn:

Question 3: "Is it common (or is it becoming more common) for an agent or agency to offer its customers a full line of insurance products from property to life to health?"

PIA members sell and service all lines of insurance but have special expertise in the property/casualty side of the business. As independent business owners, each represents several insurance companies, and has access to a greater number of insuring markets through brokerage agreements. Within this context, an increasing number of agents are moving into providing life and health coverages to their clients. This expanded scope of coverage will enable them to provide maximum insurance protection tailored to meet their clients needs at the best available price. This trend will, in all probability, continue as more and more agents strive to offer their clients a broader range of insurance products and services.

"Are more agents beginning to offer mutual funds?, CDs? financial planning?"

No. Based on our knowledge, PIA members have not been inclined to enter into offering the aforementioned financial services. This may, however, be the case where certain security firms are also engaged in the business of insurance.

The Honorable William Proxmire
February 24, 1987
Page Two

It is important to note that the fundamental nature of the products sold by insurance agents are independent insurance products. Sales are not linked to or influenced by the ability of a depository institution to leverage credit to enhance sales.

PIA believes that tie-in sales would occur if banks and bank holding companies were granted general authority to sell insurance. PIA and its insurance allies will continue to oppose banking institutions that seek to obtain the authority to engage in the general business of insurance sales and/or underwriting.

Sincerely,

Patricia A Borowski

Patricia A. Borowski, CPIW
Vice President
Government and Industry Affairs

PAB/CWW/tcm

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ROBERT B. EVANS

Q. 1. Do you support the concept of a financial services holding company that was put forth by the Association of Bank Holding Companies?

A.1. As you know, AFSA's members believe that free entry and competition best serve the consumer and the industry alike. The Association of Bank Holding Companies proposal is a step in the right direction, especially in its structural concept, but it needs to address the ownership of banks by diversified ("commercial") entities -- and vice versa -- before it can meet the criterion of free entry and thereby gain AFSA endorsement.

We believe that the financial services industry -- including banks -- should be made strongly competitive in the U.S. and around the world. For this to happen capital infusion must come into the banking industry from without. What better place -- from a public policy viewpoint -- than U.S. commercial interests rather than those of London and Tokyo?

Q. 2. On pages 19 and 20 of your written statement, you urge that the FSLIC fund be recapitalized "as soon as possible" otherwise it is a "disservice to taxpayers since it has the effect of increasing their liability that Congress has already pledged."

Chairman Gray and the U.S. League have urged that closing the nonbank bank loophole be coupled with any FSLIC recapitalization otherwise the latter could be made much less effective and ultimately much more expensive. That, in my view, would be a disservice to taxpayers, for as you noted, they do stand behind the fund. Do you agree? If not, why not?

A.2. We disagree. Chairman Gray is looking at a small potential addition (he has not told us how much) to be a failed thrift's balance sheet by creating -- through scarcity -- an artificial "franchise value." Assuming businessmen will pay some "going concern value" to acquire even a failed business, and a possibly somewhat more if the government is in the business of allocating charters, one must measure this anticipated windfall to the FSLIC against the price being paid.

Upwards of 1,000 savings and loans continue to create new claims on the FSLIC in an amount estimated to range between $2.25 and $4 billion a year. If the government can not afford to close these failed thrifts down today for lack of FSLIC funds, it clearly will not find this kind of money in an occasional premium paid by a company eager to get into limited purpose banking. Indeed, no one has seriously urged that the potential franchise value of all failed savings and loans comes even close to offsetting the horrific losses allowed to mount in just one year.

A better way would simply be to close down these losers and invite competitive bidding on the assets from all qualified comers.

Q. 3. **You claim on page 9 of your written statement that the popular contention that nonbank banks exist because of "some loophole in the law is simply wrong" and you cite the Supreme Court's decision in the Dimension case to support your contention that the existence of nonbank banks "is the will of the Congress."**

I thought that in Dimension the Supreme Court said only that the definition of bank in the Bank Holding Company Act did not cover the new phenomenon of nonbank banks. In that case the Court said among other things, "the statute may be imperfect . . . Without doubt there is much to be said for regulating financial institutions that are the functional equivalent of banks." The Eleventh Circuit in the U.S. Trust case acknowledged that the result "clearly frustrates the Congressional purpose in the Douglas Amendment of the Bank Holding Company Act." In 1984 the Senate voted 89-5 to close the nonbank bank loophole, and the House Banking Committee has voted to do the same.

How do you claim in light of these facts that the existence of nonbank banks is the "will of Congress"?

A. 3. The Dimension decision traces the legislative history of the Bank Holding Company Act of 1956 showing Congress' continuing narrowing of the application of the Act. The 1956 Act defined banks as "any national association or any state bank, savings bank, or trust company". 12 U.S.C. §1841(c) (1964 ed.) As the Chief Justice said in Dimension " e experience soon proved that literal application of the statute had the unintended consequence of including within regulation industrial banks offering limited checking account services to their customers."

Accordingly, in 1966 the Congress narrowed the definition to limit its application to institutions that accepted "deposits that the depositor has a legal right to withdraw on demand." Recognizing that the 1966 definition was also too broad, in 1970 Congress again narrowed the definition to provide that a bank is any institution that "(1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans."

Thus, Congress has worked its will three times, each time narrowing the definition of the term "bank".

As your question notes, in 1984 the Senate voted 89-5 to pass comprehensive banking legislation of which the "nonbank bank loophole" was one small segment. In the 99th Congress no such bill was passed.

As the question also notes, the House Banking Committee has passed legislation to "close the loophole", however the full House has never voted on any such legislation. Thus the Congressional intent demonstrated in 1970 remains the law.

Q.4. **You have recommended that the Congress create a new class of financial institutions called "consumer banks", whose activities would be confined largely to making consumer loans. This proposal runs counter to the**

trend of financial institution legislation over the last 20 years to eliminate distinctions among depository institutions. Certainly the experience of the savings and loan industry demonstrates the dangers of becoming too specialized in one form of credit. One of the strengths of commercial banks is their diversity: they make both consumer and commercial loans.

Wouldn't we run the risk of creating more financial instability if we adopted your consumer bank concept?

A.4. Consumer banks exist and have existed for many years in the form of consumer-oriented commercial banks, industrial banks, savings and loan association, and most recently the so-called nonbank banks. The American Financial Services Association does not recommend creation of new limited-purpose financial institutions, but rather it recommends that all providers of financial services have expanded freedom within a competitive market to supply the financial services their customers demand. Thus, diversified companies that own consumer banks should not be eliminated from the marketplace as your proposed legislation would do. Instead, diversified companies should be encouraged to continue providing capital management, and innovations to the marketplace as they have done for many years.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

ROBERT B. EVANS

Q. 1. **One reason often advanced for prohibiting ownership of insured depository institutions by their firms within or outside the financial services industry is that these firms are engaged in such risky activities that they would endanger the insured depositories. What does recent experience tell us about the relative riskiness of commercial paper underwriting vs. lending to the energy industry, or underwriting insurance vs. lending to Latin American LDC's?**

A. 1. Certainly recent experience has shown that many forms of lending are riskier than many other activities. You present good examples. Underwriting prime commercial paper is low-risk service that banks could provide their customers, thereby earning fees to offset same of the preserve on profits and capital which have arisen in the energy and foreign lending areas.

Q. 2. **What does recent experience teach us about the usefulness of diversification as a technique for reducing risk? Might a consumer bank affiliated with a diversified company be a less risky entity than a stand-along bank?**

A. 2. Economic theory are well as experience demonstrates the usefulness of diversification as a technique for reducing risk. The experience of many agricultural banks whose loans are not diversified either geographically or by industry provide graphic illustration of the potential problems with undiversified portfolios. Experience in the 1920's and 1930's was similar when undiversified agricultural banks fared far worse than institutions which diversified their sources and uses of funds. Such experience contrasts sharply with the strategies of the owners of today's consumer banks who are trying to diversify their own assets and liabilities while serving their customers' needs in a competitive marketplace.

Q. 3. **If a diversified owner of a consumer bank got into financial difficulty, what authority should be given to bank regulators to prevent the parent from becoming too dependent on its bank subsidiary?**

A. 3. Current federal law is designed to prevent a parent from becoming too dependent on its bank subsidiary. §23A of the Federal Reserve Act (12 U.S.C. §371(c)), applicable to all insured banks (12 U.S.C. §1828(j)), places strict limits on loans to affiliates. Loans to any one affiliate are to limited to 10 of a bank's capital and aggregate to all affiliates are limited to 20 of capital. §23A also provides the same limitations on the purchase of assets from affiliates. These limitations also apply to any transaction by the bank with a customer of its affiliates to the extent that an affiliate may be the ultimate beneficiary from the transaction.

A bank may not purchase a low quality asset from an affiliate (12 U.S.C. §317c(a)(3)) nor may purchase an asset at more than its fair market value (F.R.B. Letter Opinion, September 5, 1975, CCH ¶96,715 (1975)).

Thus, a bank's financial condition cannot legally be affected by affiliate transactions and therefore a parent corporation cannot become "too dependent on its bank subsidiary." If a parent company becomes financially troubled, it is precluded from misusing the bank for its own ends.

Q. 4. **How could a diversified company owning a consumer bank be prevent from threatening the payments system through improper use of the consumer bank? Full service bank?**

A. 4. The provisions of §23A outlined in Question 3 above prevent the improper use of a consumer bank as well as any other insured bank. To the extent there are violations of the banking standards mandated in §23A, the penalty provisions of 12 U.S.C. §504 which govern banking law violations apply. This provision includes civil penalties of up to $1,000 per day. Additionally, personal civil liability for the officers and directors of both the bank and the diversified company provide a deterrent. It is very likely that a civil RICO action could also be brought against those misusing either institution.

It is difficult to foresee any example of how the payments system would be put at risk through the improper use of a consumer bank in violation of §23A. The key function of the payments system is to operate a check collection clearing house system. There has been no substantial risk to this segment of the payments system by any class of institution.

There is one aspect of the payments system which has raised concern that unsound banking practices may create a risk to the entire system. That is through a daylight overdraft resulting when a bank sending funds to the payments system fails to cover its obligation. Although computer failure has caused one large accidental daylight overdraft, AFSA is unaware of the existence of any deliberate creation of daylight overdrafts by consumer or full service banks.

This risk, if it can be shown to exist or is shown to be somehow perculiar to diversified companies (a notion AFSA strongly rejects), can be eliminated by requiring that all extensions of credit -- including intraday extensions of credit through daylight overdrafts -- be fully collateralized.

5. **What is the likely future for the banking industry if banks are not allowed to affiliate with other financial intermediaries while freedom to affiliate and innovate is given to securities firms, insurance companies, finance companies and others?**

Banks will be disadvantaged relative to their competitors if the competitors are able to provide financial services and combination of services that customers desire but which banks cannot provide. Thus, if securities firms, insurance companies, and finance companies can affiliate, innovate, and provide expanded products and services to customers in ways that banks cannot, the banks will lose ground relatively in the marketplace. In this context we recently witnessed the Chairman of Chase Manhattan Bank, one of our nation's largest banks, reveal that he was thinking of relinquishing the bank's charter. This would permit Chase Manhattan to become a securities firm, an insurance company, and a finance company rather than a bank and eliminate many current restrictions or its activities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ROBERT A. GERARD

Q. Are municipal revenue bonds inherently more risky to underwrite than general obligation bonds?

A. Yes. General obligation bonds are backed by the full taxing power of an issuer; revenue bonds depend on the success of an enterprise. The revenue bonds of the Washington Public Power System which defaulted are a case in point. There is no source of revenue to pay the interest or principal on those bonds. I believe this distinction was recognized at the time Glass-Steagall became law, since revenue bond financing stretches back to the early years of this century. Revenue bonds have become more popular as the desire to identify project costs to users rather than to general taxpayers has increased.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ROBERT A. GERARD

Q1. How many members of SIA own nonbank banks? What percentage is this of your membership?

A. SIA does not maintain any statistics which would show this information.

Q2. What is the SIA's position regarding nonbank banks? Do you favor closing the nonbank bank loophole? Assuming the continued separation of commercial and investment banking, do you support the divestiture of all nonbank banks by securities and insurance firms? If not, how do you justify the access of securities firms to federally insured deposits when banks are denied authority to engage in the full range of securities activities: Isn't the access to insured deposits one of the principal arguments against allowing commercial banks to engage in investment banking?

A. The SIA Board has not adopted a position on nonbank banks. The Board has consistently supported the separation of commercial and investment banking. The Board has not adopted a position relating to divestiture. Some SIA members support nonbank banks. Other SIA member firms have spoken out in favor of closing the nonbank bank loophole. Other members have taken the position that as long as there is a threat that banks will obtain securities powers they should have some banking powers. This feeling has perhaps become stronger since banks won securities brokerage powers through regulator action and court interpretations.

Q3. Your testimony mentions the possibility of "tie-ins" and conflicts of interest if bank holding companies were to "cross-market" securities products to their bank customers, and that this possibility warrants the absolute prohibition against banks offering such securities products. Do securities firms (and other commercial firms, for that matter) have any opportunities to cross-market different products and services? For example, can't brokerage firms advise customers to purchase products and services (such as annuities and mutual funds) from affiliates of the brokerage firm rather than independent companies? Should these activities be prohibited rather than regulated? What about brokers who provide investment advice -- don't they have a financial incentive (commissions on transactions) to urge purchases and sales regardless of the benefit to the customer? Isn't this a conflict of interest? What about investment banking firms that provide mergers and acquisition advice while at the same time having the ability to deal in any security in the market -- including takeover stocks? Isn't this a blatant conflict of interest situation? Should this dual capability also be prohibited rather than regulated?

A. I am afraid that these questions proceed from a false assumption: that banks and brokers are alike. They are not. And this is the operative point: banks are different. They are given a franchise, a kind of monopoly, they are supported by federal deposit insurance and ultimately the credit of the federal government. We know since Continental Illinois that there are banks which are too big to fail and that will be propped up no matter what. Traditionally, banks have had better tax treatment than other kinds of companies. Bank difficulties are kept quiet if they can be and are worked out by the regulators so that confidence in the banking system will be maintained. Brokers operate in a full disclosure environment. Banks have special accounting rules that make even their published figures look better than they might if they had to, for example, mark their shaky loans to their market value. Banks have access to federal funds and the Federal Reserve discount window. All of these advantages, practically all of them conferred by the government, give banks a special, protected place in our society. This is perfectly right and proper for banks to do their job as banks. However, when they venture outside of banking and use their special position and clout to compete against people who do not have those special advantages, that is unfair. What we object to is the unfair leveraging of that government backing in competition with those who do not have that government backing. As early as 1982, in testimony before the Securities Subcommittee of the Senate Banking Committee, we specifically dealt with the problems of unfair bank leveraging and how it might be avoided. (See Senate Print 97-47, pp. 437 et seq.)

Q4. What percentage of your members engage in lending activities in addition to securities activities, for example, Prudential Bache and General Electric Credit Corporation? Does this lending ability raise the same kinds of conflicts of interest as you argue is present with banks? Should this blending of commercial lending and securities activities be prohibited?

A. Virtually all securities firms engage in some kind of lending, for example, in margin accounts. SIA does not, however, maintain any statistics on lending activities. The lender-borrower relationship that results when insurance companies on consumer finance companies provide credit is significantly different than that which develops in a commercial bank lending relationship. Since the lending base is unrelated to government backing and the availability of low-cost funding from insured deposits or federal funds, we do not believe the same problems of tying or unfair advantage are presented.

Q5. Your principal objection to banks' underwriting and dealing in municipal revenue bonds is their ability to "tie-in" letter of credit services. How many lawsuits have successfully established this practice? Shouldn't the solution be to restrict or regulate such arrangements rather than prohibit the underwriting altogether?

A. Our principal objection to revenue bond underwriting by banks is that it represents a piecemeal repeal of the Glass-Steagall principle. We believe that principle is sound and has permitted two strong financial industries to flourish side by side, one buttressed and protected and furnished with low-cost funds by the government to perform certain utility-like banking functions essential to society, the other operating in a free enterprise, full disclosure environment to provide alternative methods of raising capital. The first business, as it should be, is marked by stability and regularity of earnings, the other is characterized by volatile earnings and wide cyclic swings. We think the purposes of the institutions are different and their modes of operation are different. One is typified, in the words of one Supreme Court opinion, by the "objective lender." The other is built on entrepreneurship. The worlds compete and collide, but are different. This nation has benefitted from this diverse, dynamic system brought into being by the Glass-Steagall Act. Therefore, since we believe in it, we object to seeing it destroyed a piece at a time.

The problem with this kind of tying is that it is so insidious it is difficult if not impossible to regulate. Tying occurs with a wink or a nod or a broad hint: the point is made, the tying occurs. The issuer is often dependent upon the bank for other banking services or the credit facility and has little choice but to yield to the subtle pressures towards awarding a managing underwriter slot to the bank. For example, in bank-eligible housing issues this kind of bank leveraging has been common. Do you think an investment banker, dependent upon his commercial banker for his regular loans, is going to sue the bank? Hardly. A survey that was done of the activities of three banks providing credit support for housing put bonds revealed that in 24 cases out of 24 the banks also wound up as managing underwriters. This hardly seems coincidental.

Q6. In its application to the FDIC regarding its nonbank bank, Goldman Sachs, one of your members, indicated its intention to provide letters of credit to customers. Given your repeated objections to banks' ability to use letters of credit with securities activities, particularly municipal revenue bonds, do you object to the Goldman Sachs proposal as well? Do you believe that all firms engaging in securities activities should be prohibited from providing letters of credit?

A. I have not seen the Goldman Sachs FDIC application, but I would be astounded if Goldman Sachs indicated that it was going to use letters of credit in connection with underwriting transactions in which it was going to serve as a manager. I believe that letters of credit founded upon a government supported deposit base should not be used as leverage by anyone.

Q7. Your testimony states that the securities firms now in the municipal revenue bond business "assure issuers the full benefits of competition." If that is true, how do you account for the fact that state and local trade associations overwhelmingly support increased bank participation, such as the National Governors Association, the National League of Cities, the Government Finance Officers Association, the American Public Power Association, and the National Conference of State Legislatures?

A. I cannot vouch for the positions of the organizations you cite, although I am aware that from time to time such positions have been taken. Such positions are easily explained. There are thousands of banks throughout this country which constantly serve public issuers in various capacities. These banks have been very diligent over the years in campaigning for the support of public issuer groups for revenue bond underwriting by banks. It is very difficult to say no to your bank because you must rely upon the bank for so much. But there has been no evidence advanced that bank entry into revenue bond underwriting will provide cost savings to issuers. The major bank effort to "prove" that savings would result was thoroughly explored before the House Banking Committee in extensive hearings in 1979. The hearings conclusively show that the claimed savings do not exist. The reason for this is that there is much more than a critical mass of broker-dealers presently operating in the revenue bond area so that vigorous competition is assured. And, of course, there are other considerations which are not the concern of issuer groups. What is best for banking? What is fair competition? Would banks crowd out broker-dealers who do not have the advantages banks have? For example, in 1981, in hearings before the Senate Banking Committee, the Secretary of the Treasury agreed that allowing banks to underwrite in the bank would constitute unfair competition.

Q8. Your testimony states that the market for mortgage-backed securities is less organized and less liquid than the market for corporate securities. Wouldn't the participation of banks in all aspects of this market help on both counts?

A. The point being made was that banks had really benefitted greatly from the creation of the mortgage-backed security because it provided them the opportunity to rid their portfolios of fixed-rate long-term loans, thus shifting interest rate risk away from the banks to the market. From that point of view it would make no sense to allow or encourage banks to reassume the risks they were shedding with the sale of their fixed-rate mortgage portfolios by wading into the MBS market. The non-government-backed MBS market is newer than the corporate market and has not yet achieved the same degree of liquidity. However, market participants are making steady progress in that direction and have evidenced no inability to reach the desired state of organization and liquidity. Banks with their assets, their access to low-cost money and liquidity have many challenges in banking, from agricultural and energy loans to international debt, for which they have been given their advantages, which need their attention. The jumbo-mortgage market has no such need.

Q9. Your testimony states that "banks should not be trying to raise capital to get into even more risky business such as securities underwriting." How does this assertion jibe with the recent acknowledgement by Merrill Lynch -- the nation's largest securities firm -- that "there is no evidence that securities activities are any riskier than other activities with which banks are associated, and a good deal of evidence that securities activities are not as risky as banking itself"?

A. I have not seen the Merrill Lynch statement from which you have quoted, so I do not know its context. The kinds of risks involved in securities underwriting and dealing are different from the kinds of risks banks generally undertake. Banking has its set of risks as underwriting has its kinds of risks. Banks are provided with government support and various advantages so that they will take on the kinds of risks that we all associate with banking. Of course there are significant risks in banking. International loans, energy loans and agricultural loans are all evidences of the kinds of risks that banks take on. Securities underwriting risks were largely left outside the government support umbrella when the Banking Act of 1933 became law. With banks laboring with the problems they have, is this the time to add securities underwriting risks to the government support umbrella? In a recent quarter securities firms reported trading losses in the hundreds of millions of dollars; why should the banking system be inflicted with these kinds of risks? If there is a feeling that banks should take on these kinds of risks and get further and further into the securities business, then the question should be asked as to whether or not, in the interests of competition in banking, securities firms should be granted banking functions and provided with some of the governmentally-conferred advantages which banks enjoy? Rather than take down the Glass-Steagall wall in a way to benefit banks only, perhaps the wall should be removed altogether so that securities firms could engage in full-scale insured deposit taking. I myself do not favor such a course, but it is at least something which should be looked at.

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Garn — Gerard

Q10. If securities activities are more risky than commercial lending, how can securities firms consistently operate with up to twice the debt to equity ratios of commercial banks, but with fewer failures?

A. I do not believe I characterized the risks of securities underwriting as necessarily greater than the risks banks undertake. The risks are different. There is usually more volatility associated with the risks of underwriting and dealing than there are with bank loans. Government supports the kinds of risks banks undertake; we question whether government should be supporting for banks risk-taking in the securities area. We certainly do not quarrel with government support for traditional banking functions; that is part of the fabric of Glass-Steagall: protected banks operating under close regulatory supervision taking on a defined role in our society; securities firms, free to fail, operating in a full-disclosure environment so that investors, not the securities firms, will be protected as they invest funds in capital-raising ventures. The securities business is very cyclical and there were many failures in 1969 and 1973-74, so it may not be accurate to say there are fewer failures in the securities business. A principal reason that securities firms can function with lower capital to debt ratios is that securities firms must constantly value their assets at their real worth. Therefore, at any one time one can have a high degree of confidence in what the financial condition of a securities firm is as reflected by its financial statements. Banks, on the other hand, do not "mark to market" and, consequently, the condition of banks is often not accurately represented by its financial statements. If, for example, South American debt were realistically valued on the balance sheets of our largest banks it is questionable whether even their stated net assets would be sufficient in all cases to cover the write-downs of such loans. The same could be said for agricultural and energy loans. Therefore, with bank capital in many cases being insufficient to cover possible loan losses, is this the time for banks to be diverting capital into other businesses requiring significant capital such as securities underwriting and trading?

Q11. You mention in your testimony that certain institutions were grandfathered under the International Banking Act of 1978 to permit them to engage in both banking and investment banking in the United States. What are the names of these institutions? Do you support a divestiture program to separate these functions in these institutions in order to preserve the dichotomy between banking and investment banking?

A. I understand that there are 15 such institutions and that a list of them can be obtained from the Federal Reserve Board. They pose a very difficult problem, in my view. Congress, with due deliberation, decided to leave this limited number of banks alone in 1978 just as years earlier it left alone various bank holding companies that had entered upon interstate banking before Congress acted to prevent it. Your question about divestiture opens up for me what is the real challenge facing Congress: is it not time to reexamine all of the laws governing the relationship of the banking and investment banking industries, from Glass-Steagall and the securities laws to the Bank Holding Company Act and the International Banking Act? There are anomolies. There are loopholes which have been opened by regulators such as the nonbank bank. Should thrifts be brought into the picture since they have been granted commercial bank-like powers? Should a subsidiary of a state-chartered bank in a bank holding company have greater powers than is permitted to any other subsidiary of that holding company? Should national policy in this area be set by Congress or by a series of state actions that inevitably cannot take into account what is best for the nation's overall financial system? SIA has been a consistent voice calling for a thorough, top-to-bottom review of these laws. We have been heartened by the recent round of editorial support for such a review. We believe Glass-Steagall and the kind of structure it created has been good for the country. We think it should be strengthened. However, if it is to be changed, let it be after full and fair consideration of all of the factors with the goal of achieving what is best for the nation.

What Congress is looking at now is a bank wish list. Banks, with their tremendous clout and reach, have generated a feeling that what they want is somehow necessary for them to compete and stay healthy. Revenue bonds have nothing to do with international competition. Pointing to Tokyo to justify breaking down Glass-Steagall is just wrong: Article 65 is just as definite in separating banking and investment banking as is Glass-Steagall. Well-managed large banks seem to be doing as well financially as they have done at any time in the past 15, 16, 17 years. A great deal of misinformation is being circulated to justify this bank wish list. It is the job of

Congress to sort out the true facts, to take a look at the entire picture and to craft the financial framework for the next 50 years. It should not be stampeded by bank demands. There is no crisis in revenue bonds, private mortgage-backed securities or commercial paper.

Where do we want to go? Do we want to see a diminishing pool of financial competitors, the sure result of expansion of bank powers? Right now, anyone, except a commercial bank, can enter the securities business. Should that change? New York Fed President Corrigan has put a new proposal on the table that would give banks significant entry into the securities business (and the insurance business), but would limit access to others. Is that the way we as a nation want to go? There are many questions to be asked and answered. Some of them are articulated in my written statement to the Committee.

Congress certainly wants to have a healthy banking industry. So do we. By the same token, we believe it is in the interests of the nation that the securities industry be strong and healthy as well. Glass-Steagall has given us a diverse, competitive financial system. It is functioning well. It is based on the assumption that the core institutions, banks, should be protected and advantaged by government to perform basic banking functions. They should be able to operate with sufficient profit to sustain themselves in good health. The stability provided by that government support means profits year in and year out, extraordinary circumstances aside. Banks are set up to operate like utilities and by and large operate without wide fluctuations in profits. That is a major benefit of government support. Banks now say that they want to be able to achieve the high returns that are sometimes possible for securities firm. Will they also experience the lows? Should this kind of cyclicality be introduced to the banking system? How do you remove the government support so that banks will not be unfair competitors as they move outside of banking seeking these profits? Should government be supporting this drive for high profits or reasonable profits to support the bank utility functions?

We urge the Senate Banking Committee to lead the way in undertaking the comprehensive review that is required. We pledge our complete support to that effort. We think the Glass-Steagall approach will be vindicated.

Q12. As you are undoubtedly aware there are two major proposals for recapitalizing the FSLIC. One is from the Treasury Department and the other is the U. S. League of Savings Institutions. Would you please compare the two plans, looking at them from an investment banker's point of view?

A. I will contact firms within our industry to see if they can provide you with the kind of analysis that you wish. Neither my firm nor SIA is equipped to make such an analysis.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

Alan Fox, Consumer Federation of America
Michelle Meier, Consumers Union
Franci Livingston, Public Citizen

Q. 1. In the last few years, several states have passed check hold legislation. The availability schedules that have been established under these laws have been tied to the actual time it takes for a check to be returned unpaid. What would be the potential losses to the banking system if the federal government mandated availability schedules shorter than the time it takes various types of checks to be returned unpaid?

A.1. Many of the check hold limits established by state law are not tied to actual return times. We have seen no evidence to suggest that bad check losses would increase significantly under mandated availability schedules that do not reflect return times. Our conclusion that bad check losses would not significantly increase under these schedules is based on A) successful experience under state law and industry practice that rely on check hold periods shorter than return times, and B) the fact that the present use of hold periods is ineffective protection against bad check losses. We discuss both these points after a brief description of the legislation we have urged the Committee to adopt.

The general scheme for legislation should be to require banks to make funds available on a schedule that reflects the period of time required for the bank to receive credit for the category of check deposited, i.e. within 1-3 days after deposit. The 1-3 day availability would not apply to all checks. Rather, specific exceptions, such as exceptions for new account holders and large dollar amounts, should be provided for circumstances where a bank may be at risk. This scheme properly recognizes that long holds should be applied only on an exception basis since the vast majority, 99%, of checks are good. Even those checks that are returned do not typically result in actual loss to the bank because the bank can usually recover from its own depositor.

A. State Law and Industry Practice.

Eight states have adopted mandatory availability schedules. Some of these laws are based on estimated return times, while others are not. Massachusetts law, for example, does not take return times into account. That law, which has been in effect for almost two years, requires two day availability for checks drawn on any bank in the entire New England region and four day availability on checks from outside that region. Similarly, Missouri law requires banks to provide next day to five day availability depending on the category of check. In both cases, exceptions are allowed in situations where a bank may be at risk. Last August, the Massachusetts Commissioner of Banks conducted an informal telephone poll to determine if there had been any increased losses by banks as a result of the regulations. The parties surveyed included the Federal Reserve Bank in Boston, major correspondent banks, trade associations and a small sampling of commercial banks. The Massachusetts Commissioner of Banks stated of this survey:

> The overall response was favorable. The regulations are considered fair to both consumers and banks. No documentable instance of loss could be attributed to the regulations.(emphasis added)

The success of the Massachusetts law demonstrates that short holds, with exceptions in potentially high risk circumstances, are workable today. This is true even without improvements in the check return system and despite the fact that Massachusetts law is not based on return times.

Other state laws require check hold periods shorter than estimated return times for specific categories of checks.

Additionally, some banks already have hold practices that are as short or shorter than what we urge. In testimony before the Banking Committee in 1983, Bank of America stated that it places holds, only on an exception basis, on less that 1% of the checks it receives. These holds are imposed only on a case-by-case basis depending on the risk of loss repesented by a particular check. A 1986 nationwide survey of 458 banks and savings and loans conducted by the U.S. Public Interest Reseach Group, in addition to finding a high percentage of lengthy holds, also documented that 22 percent of the banks grant immediate access to local checks and 9 percent grant immediate access to out-of-state checks. These practices demonstrate that banks are presently able to grant customers quick access to their funds.

B. Present Hold Periods Are Ineffective Protection Against Bad Check Losses.

Some members of the banking industry argue that legislated reductions in hold periods should not occur until the check clearing system has been improved. A bank should not release deposited funds, this argument goes, until enough time has elapsed for it to be confident that the check has been honored by the bank on which it was drawn.

There is no need, however, to delay implementation of a holds schedule that is based on receipt of credit by the bank of deposit. This is bècause the present use of long holds does little toward protecting a bank against loss that could not be achieved by allowing banks to impose such holds only in potentially high risk circumstances.

Long hold periods are based on crude estimates of the time it takes for any category of check to be presented to the payor bank and returned to the bank of deposit. However, these estimates do not protect a bank when a customer intentionally writes or deposits a bad check. Someone who wished to defraud a bank by receiving cash for a check written on insufficient funds can do so now by tampering with the check's magnetic strip, which is used to make the check machine readable for sorting purposes during the forwarding process. This delays the check in its forward movement toward the payor institution, requiring the processing banks to handle the check by hand. Even the longest hold periods could be ineffective against this kind of scheme.

In spite of long holds, the present clearing process also leaves a bank vulnerable to losses on checks with forged signatures. Because of the large volume of checks, a payor bank does not usually have the time or resources to determine whether signatures are valid. At most, the payor bank is able only to check to make sure that endorsements and signatures are actually present. By the time a forged signature is discovered, which is likely to be at the time the customer reviews his monthly statement, even a lengthy hold period has already passed.

In fact, holds are not effective protection to banks against losses in many instances because dishonored checks arrive at the bank of deposit long after a hold period has expired. A three week survey of return items by a New York savings institutiton and summarized by the United States League of Savings Institutions in the 1983 Senate hearings showed that the forward and return process "almost always exceeded the hold period and usually by a significant number of days." The U.S. League noted:

> ...while the association uses the equivalent of a seven day hold for items drawn on institutions in metropolitan New York, only 1% of checks returned by local institutions were received within the seven-day hold period. About 90% took at least 10 days to be returned, 54% took at least 13 days, and 10% took more than 15 days.
>
> The association had a similar experience with items drawn on institutions outside the metropolitan area. For these items, the association uses the equivalent of an 11 calendar-day hold. About 10% of these return items were received with 11 calendar days. About 60%, however, required at least 16 days to be returned and 10% took at least 20 days to be received.

Q. 2. Is it possible to be sufficiently precise about the check-return technology that will be available over the next five or ten years to justify legislating availability schedules now?

A.2. The check hold legislation we urge is not premised on improvements in technology. Instead, we urge a system of 1-3 day availability with exceptions for those circumstances where a bank may be at risk. The check return system could be improved at any time to eliminate the need for exceptions but that does not justify postponement of a system that relies on exceptions.

The legislation introduced by Senator Dodd provides that, by the end of a four-year period, the Federal Reserve Board must issue a funds availability regulation. In promulgating this regulation, the Board could proceed under one of two options. The basic difference between these options is that one requires an improved return system to protect banks from undue risk while the other relies on exceptions to perform this protective function.

The first option requires the Board to improve the check return system so that a depository institution could reasonably expect to learn of dishonor within the time periods established by the availability schedule. Under this option, the regulation would allow up to four intervening days between the day of deposit and the day of availability. This outside day limit could be extended to five intervening days by the Board if the extension is necessary for banks to reasonably expect to learn of dishonor under an improved return system. In either case, the Board would base the schedule on the forward and return times for particular categories of checks. This option provides three exceptions to the mandated availability schedule: for checks where the bank of deposit has a reasonable suspicion to believe that the check is uncollectable; for emergency situations such as suspension of payments by another depository institution; and in cases where the Federal Reserve temporarily suspends the availability schedule due to fraud losses for a particular class of checks.

Option two requires the Federal Reserve to issue an availability regulation without improving the return system. The Board would tier the schedule based on the time needed for the bank of deposit to receive credit for the check, considering geographic location, the type of institution involved, and type of instrument.

Option two would allow the Board to promulgate additional exceptions to the availability schedule including exceptions for new account holders, large dollar amounts, deposit accounts that have been overdrawn repeatedly, checks that have been returned unpaid and redeposited, and any other class of checks where the Board finds, based on substantial evidence, that such class poses a serious risk of loss to depository institutions. In addition, the three exceptions from option one would apply to this option as well. This option contains more exceptions than option one because it relies on the exceptions, rather than improvements in the check processing system, to protect depository institutions from potential risk.

There is no need for this bill to be premised on any particular technology. Under the bill, the Board can choose one or any combination of twelve different methods for improving the check return system such that banks could reasonably expect to learn of dishonor of a check in four or five days after deposit. Consequently, the Board has flexibility in determining the method for improving the check return system over the four year period.

The Board could also decide to proceed under Option two. This option relies on exceptions to the mandated hold periods and requires no improvements in the check clearing system. The Board would be most likely to proceed under option two if it determined that improvements in the check return system are not cost-effective.

Neither option requires Congress to specify, four years in advance, a particular method for improving the check return system. If improvements in the check return system prove to be impractical, the Board can proceed under option two, which, because of its reliance on exceptions, is workable under the present return system. Additionally, the Dodd bill should provide the Board continuing authority to improve the return system and the availability regulation. This continuing authority would allow the Board to make use of new technology.

For years, the archaic check return system has been used to justify lengthy holds and the postponement of legislation. We believe that consumers have waited long enough for the industry and its regulators to resolve the check hold problem on their own. A check hold law would provide impetus to improve the check processing system. However, no improvements are necessary and consumers need not wait for a schedule, such as option two of the Dodd bill, that allows exceptions for situations where a bank may be a risk.

Q.3.(A) If mandated availability schedules were to expose banks to serious potential losses, what is the danger that depository insitutions would stop offering checking accounts to the very people delayed funds availability legislation was intended to help? (B) Do mandated and publicly available check hold schedules encourage fraud?

A.3. (A). In our answer to question #1, we explained that we have seen no evidence to indicate that bad check losses increase significantly under mandatory availability schedules. Consequently, we would not expect that banks would increase fees or restrict availability of deposit accounts as a result of such schedules.

In a recent letter to Chairman St Germain, the Massachusetts Public Interest Research Group (MASSPIRG), citing surveys conducted by the Massachusetts Executive Office of Consumer Affairs, concluded that fees had not increased following passage of the state funds availability law. MASSPIRG stated: "These fees, which had been rising sharply in 1984 and 1985, showed a much slower increase in the Fall 1986 survey, which was conducted approximately a year after the new law [the funds availability law] took effect."

If banks have not raised fees in the wake of funds availability laws, we would not expect them to take the more extreme measure of restricting deposit account availability. In fact, the Massachusetts Public Interest Group stated in the same letter to Chairman St Germain, "We found no indication that implementation of the law has created problems for consumers."

(B). This part of the question relates to the possibility of losses due to fraud under a mandatory availability schedule. We have addressed the question of whether mandated schedules would cause increased bad check losses under question #1. The question also addresses whether the fact that a schedule is not only mandated, but publicly available, results in increased fraud. All states that have adopted availabilty schedules require that banks disclose their check hold policies. For example, Massachusetts account holders are notified of availability policies of up to 2 intervening days on New England checks and up to 4 intervening days on out-of-region checks. The fact that schedules are publicly available, therefore, does not change our conclusion that mandated availability schedules do not result in significant increases in losses because we assumed public availability in our answer to question #1. We do not, of course, believe that availability schedules should be secret.

Q. 4. Why is public disclosure of individual institution's availability schedules not sufficient to protect consumers from unreasonable holds?

A.4. We do not believe that disclosure is the answer to the check hold problem. First, it is unreasonable to expect consumers to choose a bank solely on the basis of check hold policies because numerous other variables enter that decision including loan offerings, account maintenance fees and geographic location. Second, holds are sufficiently pervasive that consumers often have relatively little choice but to accept lengthy holds policies. A survey of 31 Washington, DC area institutions, conducted by Public Citizen, showed, for example, that all surveyed institutions but four hold local checks for 3 days or more and hold out-of-state checks for over a week. Third, banks should not be permitted to use unfair practices simply because they disclose them.

Q. 5. One argument that has been advanced for mandating shorter availability schedules relates to the fact that banks often receive provisional credit for checks being collected before the banks make the funds available to their customers. As soon as the banks receive provisional credit, they can begin earning interest on the funds, but if consumers have deposited the checks in demand deposits, they must wait until the end of the availability schedule before investing in interest-earning assets. With the increasing use of accounts, which pay interest on funds from the date of deposit, has the need for funds-availability legislation been reduced? Don't the vast majority of banks pay interest on deposited checks from the date of deposit or the date the bank receives provisional credit?

A.5. We have seen no definitive studies that indicate that the vast majority of banks pay interest on deposited checks from the day of deposit or the date the bank receives provisional credit. During the mark-up of the House check hold legislation in 1985, Congressman Richard Lehman, the sponsor of an amendment to require banks to credit checks as of the date of deposit, indicated that the banks with which he had consulted each varied their deposit crediting practices according to the type of customer involved.

Even assuming, however, that most banks do pay interest on interest-bearing accounts as of the day of deposit or provisional credit, it is important to remember that a large portion of all deposit accounts are still non-interest bearing. Many consumers are unable to meet the increasing minimum balance requirements and avoid the monthly service fees associated with interest-earning accounts. These consumers do not even earn interest while they are denied access to their funds.

In fact, we do not think that a consumer's ability to earn interest during a lengthy hold ameliorates the injustice and harm of the lengthy hold itself. The critical issue here is access. The greatest inequity to the consumer lies not in the loss of a few days interest, an amount measured perhaps in pennies, but in the consumer's inability to access needed funds in a timely fashion. The hardest hit are those who live from paycheck to paycheck and need access to their funds to cover basic living expenses.

Aside from this basic harm, which is impossible to quantify, we have estimated that consumers also suffer at least $135 million each year as a result of bounced check fees that banks impose on accounts when a check is returned because it is written against funds subject to a hold. This figure does not even include the monetary loss consumers suffer when the vendor to whom the check is written also imposes a penalty on the consumer because the check is returned.

Q.6. If a customer needs quick availability of his money, to what extent can wire transfers be substituted for check payments?

A.6. We do not believe that wire transfers offer a reasonable substitute for check payments to allow a customer quick availability. The wire transfer option is frequently presented along with the suggestion that customers can use electronic funds transfer (EFT) systems to gain quick availability, so we will explain our response to both.

For many years now, the banking industry has attempted to avoid the check hold issue by pronouncing the imminence of a new age society in which checks will be substituted with electonic funds transfers. Yet, the use of checks has actually increased since these forecasts were first announced, and there is no indication that the checkless society is imminent.

Only a very small percentage of employers provide their employees with direct deposit services, and we are aware of few other types of third party payments to consumers that are available through EFT.

Moreover, consumers are rarely in a position to ask their employer, friend, or insurance company to pay them through a wire transfer. Even in those few cases in which a consumer is reasonably able to request a wire transfer, such as when he might otherwise receive a personal check, we see no reason whatsoever to force him to use this option since a significant increase in cost is likely to be involved. We see no justification in forcing consumers to incur additional costs to avoid long blanket hold periods that have no justification anyway.

Q.7. If a consumer needs quick availability of his money, would it be reasonable to require the consumer to establish a credit line with his bank equal to the amount of credit he wants on check deposits before the expiration of the time it takes for those checks to be returned unpaid?

A.7. We do not regard this as a reasonable response to the check hold problem. First, it would force consumers to incur interest charges to avoid a practice that has no justification anyway. Consequently, this indirect solution would merely change the form of the harm consumers suffer. Second, this response is unreasonable because it falsely assumes that all consumers would be eligible for a credit line. In fact, eligibility for credit lines depends largely on income. The consumers most deeply affected by long check hold policies are those who live from paycheck to paycheck and who thus would have difficulty qualifying for a credit line. Third, this response is unreasonable because it would force all banks to grant all consumers a credit line. To this extent, this response is unacceptable not only for consumers but probably for the banking industry as well.

Q. 8. For consumers, how do the average length of check holds with credit unions and savings and loans compare with that of commercial banks?

A.8. A study by the Credit Union National Association (CUNA) claims that credit unions do not hold checks as frequently, nor as long, as other financial institutions. We know of no other similar study that confirms this fact or that differentiates other types of financial institutions.

Q. 9. Should check hold legislation apply to money market mutual funds as well as banks?

A.9. At this time, we see no justification for applying check hold legislation to money market mutual funds for several reasons. 1) We have seen no definitive study that documents abuses in this area. 2) Money market mutual funds maintain accounts at depository institutions into which they deposit fund contributions. Consequently, we would hope that undue delay in making contributions by check available to the consumer, assuming it presently exists, will be eliminated with the passage of good check hold legislation. Hopefully, the mutual fund will pass on the expedited availability it receives to the consumer. If this does not occur, consideration of additional legislation might be in order.

Q. 10. Is the proposed Truth-in-Savings legislation you support a disclosure bill only or would it also attempt to regulate the amount of fees that banks could charge for various services? Do you support such additional regulation?

A. 10. The bill we support, and that passed the House in 1986, does not regulate the amount of fees banks could charge for various services. We have not supported or proposed such regulations.

Q. 11. Do you support the same types of disclosure for money market mutual funds, insurance companies, and any other financial providers that offer comparable products? Shouldn't any disclosure requirements be applied to all providers of financial products to provide the comparison?

A. 11. The term "financial products" has been interpreted very broadly, to include insurance policies and real estate brokerage, for example. We support application of Truth-in-Savings standards to all deposit accounts and comparable products, regardless of what type of institution offers the account.

Q. 12. How much would Truth-in-Savings legislation cost financial institutions?

A. 12. Most financial institutions already produce descriptions of their account offerings, usually on slick, expensive paper with several pages. This material may cost financial institutions a substantial amount of money, but does consumers little good because it often omits important information on prices or is in a format that renders impossible comparison with offerings of other financial institutions. It will not cost financial institutions any significant amount in new costs to provide disclosure information in a usable format.

Q. 13. Can the disclosures you support truly be standardized and simplified without sacrificing worthwhile differences in financial products? For example, could the disclosures be more simply presented than Truth-in-Lending disclosures? It has been argued that consumers rarely read such complex, fine-print statements.

A. 13. Truth-in-Lending disclosures include numerous non-price disclosures describing consumers' legal rights and responsibilities. Few of the disclosures in Truth-in-Lending are explicitly related to price, and those price disclosures are clear and concise and are usually read carefully by consumers. We believe that the standardization of credit interest rate terms into a clearly defined Annual Percentage Rate (APR) has improved substantially consumers' ability to shop for credit and has eliminated what would otherwise be even more complicated and misleading fine-print elements of credit contracts.

The Truth-in-Savings bill focuses entirely on price disclosure. While there are special cases to consider in designing deposit account disclosure, it is possible to do so in a manner that highlights rather than inhibits significant differences among accounts. We note that the Truth in Lending Act has not inhibited the design of new products. Adjustable rate mortgages, home equity loans, graduated payment mortgages, stretch mortgages and reverse annuity mortgages are but a few of the many new credit products introduced since enactment of the Act.

We have suggested to the federal regulatory agencies adoption of a grid design to allow consumers to easily read such disclosures. Several different consumer organizations have developed such forms in order to clearly describe and compare the costs of a large number of accounts in one publication or even on a single sheet. Any financial institution would be able to disclose its accounts even more clearly.

Q. 14. Is it true that a large percentage of consumers, if not a majority, pay no interest at all on credit card purchases by paying their entire balance each month? And don't these consumers themselves take advantage of the float, which is sometimes as great as two months, by having in effect interest-free loans? What is the estimated value of this float on a yearly basis and is the amount factored in to your figures concerning the cost of credit cards to consumers?

A. 14. We have tried, without great success, to get a good estimate of the proportion of consumers who pay their balances in full each month, as well as of the proportion of outstanding dollar balances paid off each month. Until recently, most experts we consulted estimated that between one third and one half of all balances were paid off each month. Those figures now appear to be far too high. The Nilson Report in September 1986 stated that just 16% of credit card debt was owed by consumers who would pay the amount in full; 84% would thus be subject to finance charges. Similarly, a survey conducted by Bank Credit Card Observer and reported in that publication's October 1986 issue reported that consumers pay an average of about 20% of the amount owed. Since in many cases partial payments would still subject an entire balance to finance charges, it appears from this survey that very few bank card charges escape finance charges.

Our estimate of the cost of bank cards to consumers is based on the Nilson Report figures. We assumed, as reported by Nilson, that interest would be charged on 84% of outstanding debt. Our cost estimate also includes an estimate of the amount collected in annual fees. It does not include any allowance for nonrecurring fees such as late charges and noninterest charges for cash advances.

Q. 15. You argue that you are not supporting legislation that would restrict the availability or use of credit cards. Yet, isn't the imposition of caps on credit card rates likely to have exactly that effect? Do you still oppose a federal interest rate cap? Doesn't it make more sense to put disclosure legislation in place and gauge its effect before moving to interest rate ceilings?

A.15. As we stated in our testimony, we prefer that Congress simply restore effective control over credit card pricing to the states by allowing states to regulate, if they wish, the costs of cards issued to consumers within their borders. At the federal level, we believe disclosure legislation should be enacted immediately, but we would not rule out supporting a floating interest rate cap. We believe that fixed-rate caps could affect availability of credit under certain circumstances, but that caps that rise and fall with market conditions provide consumers and offerers with balanced protections and should not unduly affect credit availability.

We note, however, that the effect of Connecticut's reduction of its interest rate cap from 18% to 15% has been to expand available credit, and that the effect of 19.8% and 21% rates in other states is clearly the offering of credit to uncreditworthy consumers including children, prison inmates, and household pets. We do not believe that consumers are served by practices which encourage "availability" of credit to that degree.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM ALAN FOX

1. In your testimony (p. 31) you state that you favor closing the non-bank ban loophole because the loophole "undermines the regulatory structure of the banking system." However, many of the non-bank banks and other consumer groups contend that the non-bank banks are providing a much needed service to consumers that the traditional banks have been unwilling to provide. How was your position on the non-bank bank loophole determined and could you list any other consumer groups known to you that also support closing the non-bank bank loophole? What consumer groups do you know of that have supported retaining non-bank banks?

Response:

As I indicated in a letter previously submitted to members of the committee, my statement that CFA supports closing the loophole was in error. In fact, CFA has no position on the question.

I know of no consumer organizations that have taken a position on the loophole itself. Several organizations have adopted resolutions calling for the establishment of "consumer" or "family" banks which would be explicitly required by law to meet specific funds availability, community investment, and disclosure requirements. I do not interpret their resolutions as supporting retention of the non-bank bank loophole because their positions would require specific legislation establishing those requirements, and would probably imply an end to many non-bank banks operated by entities unwilling or unable to meet those requirements.

I have attached a list of organizations and individuals that have endorsed "consumer" banks. The list was provided to me by a company that advocates establishment of "family" banks under the conditions I have mentioned. I am not able to verify its accuracy or completeness, and some of the organizations listed are unknown to me; only those marked with asterisks are CFA members.

Other consumer organizations have not endorsed the establishment of such banks, generally because they believe that all financial institutions should meet such requirements. I know of no organization which has explicitly called for closure of the non-bank bank loophole; numerous organizations have been approached and asked to endorse "consumer" banks and have declined to do so, however.

CFA policy on all issues is determined at our annual membership meeting, held most recently on February 14, 1987. The annual meeting is the culmination of four days of policy subcommittee and committee meetings. All member organizations have the opportunity to participate in every stage of this process, and may submit proposals in writing even if they are unable to send a representative. The question of non-bank banks was not raised at this year's meeting.

2. Precisely how do you believe the non-bank bank loophole should be closed? Should any existing non-bank banks be permitted to remain in existence and if so, what is the basis on which you would justify grandfathering them? If not, what steps should be taken to ensure that consumers are not harmed by a complete divestiture?

Response:

CFA has no position on these questions. If any non-bank banks are grandfathered, however, we believe they should be fully covered by all consumer protection and community reinvestment statutes and that all steps possible should be taken to ensure that each such bank and its holding company are properly regulated to protect against anticompetitive practices such as tie-ins and against any threats to the deposit insurance system possible through the diversion of resources from insured to uninsured entities.

LETTERS AND POSITION PAPERS FROM GROUPS SUPPORTING CONSUMER BANKS

*American Association of Retired Persons
The National Urban Coalition
The United States Jaycees
U.S. Department of the Treasury
Coretta Scott King, President, the Martin Luther King Center for Nonviolent Social Change, Inc.
National Association of Neighborhoods
National Council of Negro Women, Inc.
West Virginia Action Group
Church Women United
National Association for Hispanic Elderly
The National Caucus and Center on Black Aged, Inc.
National Urban League, Inc.
Future Homemakers of America, Inc.
National Alliance of Senior Citizens, Inc.
American Home Economics Association
The Utah Golden Age Monthly
Utah American Association for Retired People
Utah State Aging and Adult Services
Citizens Action League of California
Sacramento Urban League, Inc.
California Department of Consumer Affairs
Michigan Avenue Community Organization
Detroit City Council
Detroit Area Agency on Aging
Milwaukee Minority Chamber of Commerce
*Concerned Consumers League, Inc., Milwaukee, Wisconsin
Central Area Senior Center, Seattle, Washington
The Neighborhood House, Inc., Seattle, Washington
Retired Teachers Association of the State of Washington
Neighborhood Housing Services of New Haven, Inc.
Call for Help, Inc., Belleville, Illinois
The Honorable George H. Ryan, Lt. Governor, Illinois
The Honorable W. Val Oveson, Lt. Governor of Utah
The Honorable Willie Lewis Brown, Jr., Speaker of the Assembly, California Legislature
The Honorable Maxine Waters, Democratic Caucus Chairwoman of the Assembly, California Legislature
The Honorable Dianne Feinstein, Mayor of the City of San Francisco
The Honorable Tom Bradley, Mayor of the City of Los Angeles
The Honorable Gilbert W. Lindsay, City Council of the City of Los Angeles
The Honorable Walter J. Kunicki, State Representative of Wisconsin
The Honorable Joseph J. Czarnezki, State Senator, Wisconsin
The Honorable Henry G. Cisneros, Mayor of the City of San Antonio
The Honorable Cyndi Taylor Krier, Texas State Senator

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM FRANCI LIVINGSTON

Q.1. In your testimony (p.31) you state that you favor closing the non-bank loophole because the loophole "undermines the regulatory structure of the banking system." However, many of the non-bank banks and other consumer groups contend that the non-bank banks are providing a much needed service to consumers that the traditional banks have been unwilling to provide. How was your position on the non-bank bank loophole determined and could you list any other consumer groups known to you that also support closing the non-bank bank loophole? What consumer groups do you know of that have supported retaining non-bank banks?

A.1. Our position on the non-bank bank loophole was determined after analysis regarding the continued existence of that loophole. This analysis left us with very serious concerns. For example, in addition to the concerns raised in our written testimony, we are concerned about:

1) the concentration of economic power that would result from increasing ownership of banks by the largest commercial firms;

2) the fact that institutions taking advantage of the loophole could collect deposits but not make commercial loans. We do not believe non-bank banks owned by commercial firms should make commercial loans because of the potential conflicts of interest. However, we are concerned about the consequences for business credit that could result if entire sectors of the banking industry collected deposits that could not be used to extend such credit. The provision of business credit is a central purpose of the banking system.

3) whether the financial troubles of the commercial parent would be separated from the perceived soundness of the bank in the mind of the public.

Additionally, we have not endorsed the concept of "consumer banks" both because of these types of structural concerns and because we believe consumer protection requirements such as funds availability, community reinvestment and disclosure requirements should apply to the entire banking industry not to one sector of the industry. We are not aware that the present non-bank banks have generally distinguished themselves by providing consumer benefits-- for example, by offering low-rate credit cards or investing or even locating in low and moderate income communities.

The other consumer groups that I am familiar with who support closing the non-bank bank loophole are Consumers Union and Bank Watch, a Ralph Nader-sponsored public interest group that works solely on financial services issues.

I do not know of consumer groups who support retention of the loophole per se. The American Association of Retired Persons has adopted a resolution supporting the establishment of "consumer banks" that would explicitly be required by law to meet consumer benefit standards. It is my understanding that Alan Fox of Consumer Federation of America is submitting a list, provided to him by Sears, of organizations that have endorsed the "consumer bank" concept.

Q.2. Precisely how do you believe the non-bank bank loophole should be closed? Should any existing non-bank banks be permitted to remain in existence and if so, what is the basis on which you would justify grandfathering them? If not, what steps should be taken to ensure that consumers are not harmed by a complete divestiture?

A.2. We have not taken a position on these questions, though we believe that any grandfathered non-bank banks and their holding companies should be covered by protections against anticompetitive practices and affiliate transactions and that the holding company itself should be supervised by the Federal Reserve Board.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
MICHELLE MEIER

Q. 1. In your testimony (p.31) you state that you favor closing the non-bank bank loophole because the loophole "undermines the regulatroy structure of the banking system." However, many of the non-bank banks and other consumer groups contend that the non-bank banks are providing a much needed service to consumers that the traditional banks have been unwilling to provide. How was your position on the non-bank loophole determined and could you list any other consumer groups known to you that aslo support closing the non-bank bank loophole? What consumer groups do you know of that have supported retaining non-bank banks?

A. 1. Our position was determined by analysis of the laws and policies governing bank holding companies, as well as by our investigation of the consumer benefits reflected in current nonbank bank operations.

As you know, the Bank Holding Company Act gives the Federal Reserve Board authority to examine the records of a bank's nonbank affiliates within a bank holding company structure. This authority is important to ensure that the bank is not financially endangered because of affiliate practices and operations. The affiliates of nonbank banks are not subject to such regulatory oversight, nor is there any indication that nonbank bank parents are willing to subject themselves to such oversight. We view this as a major threat to the safety and soundness of the banking system, which is an overiding concern of consumers, as well as federal policymakers.

We have not received information to suggest that nonbank banks are, in fact, providing services that would otherwise be unavailable. We have read many nonbank bank charter applications at the OCC, and concluded that most nonbanks that are foregoing commercial lending are targeting an upscale clientele. The banking industry in general is very keen on wooing this group of consumers, and we have little doubt that a traditional bank would service their needs equally well but for the presence of the nonbank bank. Additionally, the proposals we have seen to "legitimize" nonbank banks as "consumer banks" fall far short of what is needed to adequately serve those consumers in whom the current market seems disinterested.

Public Citizen supports closing the nonbank bank loophole. We believe the American Association of Retired Persons supports closing the locphole in such a way that nonbank banks will not operate by way of loophole but under strict laws to ensure that they, in fact, do benefit consumers. We do not view this position as inconsistent with our support of the need to immediately close the loophole for safety and soundness purposes.

I understand that there are some organizations that oppose efforts to close the nonbank bank loophole. I do not know what organizations these are.

Q. 2. Precisely how do you believe the non-bank bank loophole should be closed? Should any existing non-bank banks be permitted to remain in existence and if so, what is the basis on which you would justify grandfathering them? If not, what steps should be taken to ensure that consumers are not harmed by a complete divestiture?

A. 2. We have not taken a position on the grandfathering issue. However, we do believe that the safety and soundness concerns motivating the loophole closing should be taken into consideration. For example, if nonbank banks are grandfathered, the grandfathering legislation should ensure that the affiliates of the nonbank banks that continue to exist are subject to federal oversight. The anti-tying provisions in the Bank Holding Company Act should also be extended to apply to any grandfathered non-bank banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

DAVID SILVER

INVESTMENT
COMPANY
INSTITUTE

DAVID SILVER
President

February 17, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
530 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

We did not receive until February 9 your letter of February 6 containing questions from you and Senator Garn arising from the recently completed hearings on possible banking legislation. Nevertheless, in recognition of your desire to close the hearing record promptly, we have made every attempt to respond as quickly as possible. I would emphasize that in view of the short time frame it has not been feasible to elicit a variety of industry views nor to do extensive research.

We would make one general observation: many of the questions are limited to the narrow issues of non-bank banks and proposed bank entry into the mutual fund business. However, focusing on these isolated issues highlights a point we have long made: that a broad legislative approach to developments in the financial services industry seems preferable to piecemeal change.

Pursuing a narrow approach will have two negative effects. First, the Congress will be denied a comprehensive overview of the financial services industry -- an overview which must precede any fundamental determination as to whether or not an integrated financial services industry represents sound public policy. Second, a narrow approach will enmesh the Congress in an endless effort to balance the seesaw between the various sectors of the financial services industry as these competitors continue to develop new products and discover new loopholes.

If we can be of further assistance, please do not hesitate to call us.

With every good wish, I remain

Sincerely yours,

David Silver

Attachment

Q.1. You contend that banks should not be permitted to enter the mutual fund business because the abuses of the 1920s might recur. Does that same concern apply to mutual fund groups that have entered the banking business through the non-bank bank loophole?

Do you favor closing the loophole without a grandfather clause and forcing mutual fund groups with non-bank banks out of the banking business?

A. As set forth on pages 9-11 of our written statement, many of the widespread abuses that took place in connection with bank sponsorship of mutual funds in the 1920s resulted from the banks' roles as commercial lenders.*/ It is our understanding that most non-bank banks which are affiliated with mutual fund organizations do not make commercial loans. Therefore, it would appear that these affiliations do not raise the same concerns as does the proposed entry of commercial banks into the mutual fund business.

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*/ As stated in our testimony:

> "The abuses included fund investment in debentures of a troubled company which was financed by the bank; fund purchases of illiquid loans from the bank; and fund loans to accommodate 'good customers' of the bank. In addition, there were instancas in which the fund had invested in companies in order to further the bank's commercial interests -- for example, fund purchases of stock in other banks in anticipation of statewide branching; and so that the affiliated bank would be in a better position to sell correspondent services to these smaller banks. Other abuses included fund investment in stock of the bank; fund loans to the bank; its securities affiliate, bank officers and directors, and companies controlled by insiders; fund purchases of securities from the bank or its securities affiliate; fund investment in companies in which insiders had an interest; and fund purchases of securities being underwritten by the bank's securities affiliate." (Footnotes omitted)

We believe that the Congress is faced with a policy decision which either requires movement in the direction of a full integration of financial services, i.e., free and open competition in every aspect of the financial services business, or the restoration of the traditional Glass-Steagall demarcation between the banking business and the securities business. If Congress determines to follow this latter approach, it will be necessary to close a number of loopholes sought to be created by the bank regulatory agencies (including the Comptroller's bank IRA fund loophole, the FDIC's state bank loophole and the Federal Reserve Board's putative securities affiliate loophole). Absent a decision to move decisively in one direction or the other, present law should not be changed.

Furthermore, as we stated in our oral testimony last month, "We find it startling that an anti-competitive legislative package may be fashioned which, on the one hand, would grant securities powers to the big money center banks -- who are the only ones who would really use them --while, on the other hand, would close off all access to banking by the securities industry by closing non-bank banks."

Q. 2. On pages 9-11 of your written statement, you describe various abuses involving bank-sponsored investment trusts during the 1920s. Don't those abuses involve what would now be regarded as breaches of the investment adviser's fiduciary obligation to the investment company?

Do you contend that a bank holding company is inherently more likely to breach its fiduciary obligations than is an investment banking firm? If so, why?

Wouldn't the abuses in question be prohibited by section 17 of the Investment Company Act and by regulations of the Securities and Exchange Commission?

A. The abuses discussed on pages 9-11 of our written statement relating to bank-sponsored investment trusts during the 1920s (as well as the abuses which took place in connection with bank sponsorship of real estate investment trusts in the early 1970s) may very well have constituted breaches of general fiduciary duties or even of criminal statutes. However, the fact that widespread abuses occurred with little contemporaneous corrective action demonstrates that general criminal provisions and general concepts of fiduciary duty are inadequate. A regulatory framework containing specific statutory provisions aimed at specific types of self-dealing and conflict-of-interest transactions is needed. These types of prophylactic measures are at the backbone of the securities laws as they apply to the securities business. No such framework presently exists to govern proposed bank mutual fund activities.

In their previous testimony before this Committee both SEC Chairman Shad and the North American Securities Administrators Association ("NASAA") pointed out that the Investment Company Act of 1940 contains specific provisions designed to deal with the specific types of abuses which are likely to arise when investment banking firms and broker-dealers sponsor and underwrite mutual funds. Chairman Shad stated "For example, Section 10(f) and rules thereunder restrict the ability of investment companies to purchase securities in underwritten offerings in which their affiliates are participating, and Section 17(e) regulates commissions received by broker affiliates of investment companies in connection with investment company transactions."*/

However, both Chairman Shad and NASAA also stated that when the Investment Company Act was enacted in 1940, Congress assumed that the Glass-Steagall Act prohibited banks and their affiliates from engaging in the mutual fund business and therefore the Act does not purport to deal with the unique conflicts of interest that result when commercial banks or their affiliates engage in the mutual fund business. Thus, Chairman Shad stated:

> The Investment Company Act was adopted after the Glass-Steagall Act separated commercial banking from investment banking. Thus, the Investment Company Act could not address the problem of bank conflicts of interest specifically (Emphasis added).**/

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*/ Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, Hearings on S. 1686, S. 1703, S. 1720 and S. 1721 Before the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess., Part II, at 914-15 (1981) ("1981 Hearings").

**/ Ibid, at 914.

NASAA similarly testified that:

> At the time the Investment Company Act of 1940 was adopted, considerable attention was paid to conflict of interest potentials. With the advent of bank-sponsored mutual funds -- a liaison not envisioned in the original Act -- a close review of the conflict provisions is in order because of the existence of the potential of investor harm resulting from the relationship of banks to mutual funds. (Emphasis added).*/

Thus, Section 17 and other provisions of the Investment Company Act do not prohibit bank-specific abuses. Although Chairman Shad pointed to these defects six years ago, none of the legislative proposals considered to date have come to grips with or attempted to remedy these problems.

Q.3. On page 16 of your written statement, you state that "if bank holding companies are to be permitted to organize, sponsor and distribute the shares of mutual funds, it will be necessary to revise the Investment Company Act to deal with the unique conflicts of interest that will result." What are those conflicts of interest, and how would the Investment Company Act need to be revised to deal with them? Please be as specific as possible.

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*/ Statement of Michael Unger, President, North American Securities Administrators Association, Hearings on S. 2181 and S. 2134 Before the Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess., Part II, at 943-44 (1984) ("1984 Hearings").

A.1. Conflicts of Interest Arising From Banks' Roles as Commercial Lenders

SEC Chairman Shad and NASAA, as well as Federal Reserve Board Chairman Volcker, have testified that banks' roles as commercial lenders will raise unique conflicts of interest if banks or their affiliates are permitted to enter the mutual fund business. Chairman Shad stated: "...perhaps the most basic potential conflict of interest of a bank is that between its interests as a creditor of a corporation to which it had made a commercial loan and its duty to consider the best interests of any investment company it managed in any situation where the investment company owned or considered purchasing securities issued by the same corporation."*/ NASAA testified that "... a fund's investment in a corporation which has significant borrowing from the sponsoring bank could be abusive under certain circumstances."**/ Chairman Volcker testified that "... consideration should be given to a prohibition on loans by a bank to any entity in which a bank affiliate has a substantial or controlling ownership interest."***/

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*/ 1981 Hearings, at 914.

**/ 1984 Hearings, at 944.

***/ Statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, Hearings on S. 1532, S. 1609 and S. 1682 Before the Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 1st Sess., 162 (1983).

In order to deal with the conflicts of interest arising from banks' roles as commercial lenders, if bank holding companies are permitted to sponsor mutual funds, Section 17 of the Investment Company Act should be amended: (1) to prohibit a bank-affiliated mutual fund from investing in a company which is a borrower from the bank in order to facilitate the repayment of loans to the bank; and (2) to prohibit a bank from making commercial loans to a company in which the bank's affiliated mutual fund has invested in order to support the mutual fund, with the Securities and Exchange Commission authorized to issue individual exemptive orders and to adopt general exemptive rules in appropriate situations. Although these elementary safeguards were suggested by Chairman Shad's testimony in 1981, by Chairman Volcker's testimony in 1983, and by NASAA's testimony in 1984, none of the legislative proposals to date have incorporated such provisions.

2. Conflicts of Interest Involving Custodianship of Mutual Fund Assets

Section 17(f) of the Investment Company Act generally requires that the assets of a mutual fund be held in the custody of an independent third party, usually a commercial bank. SEC Chairman Shad has suggested that any legislation which permits banks or their affiliates to sponsor mutual funds should amend the Act to preclude a bank from serving as custodian for an affiliated mutual fund.[*/] We concur. Any legislation which authorizes bank holding companies to sponsor mutual funds should amend Section 17(f) of the Act to prohibit a bank from serving as custodian for an affiliated mutual fund, with the SEC given the authority to grant individual exemptive orders and to adopt general exemptive rules in appropriate situations. Although previous legislative proposals contained such protective provisions, more recent legislative proposals totally ignore this problem area.

3. Dumping of Shares of the Bank's Affiliated Mutual Fund into Fiduciary Accounts Managed by the Bank

The practice of banks "dumping" securities into bank trust accounts was one of the abuses that prompted the enactment of the Glass-Steagall Act.[**/] If legislation is enacted permitting bank holding companies to sponsor mutual funds, Section 17 of the Investment Company Act should be amended to prevent a bank from purchasing as fiduciary any securities issued by an affiliated mutual fund, unless such purchases are required by court order, with the SEC given the authority to issue individual exemptive orders and to adopt general exemptive rules in appropriate situations.

[*/] 1981 Hearings, at 922.

[**/] See *Investment Company Institute* v. *Camp*, 401 U.S. 617, 633 (1971).

4. Conflict of Interest Transactions Involving Correspondents

As set forth in our written testimony, in the 1920s large commercial banks caused their affiliated investment trusts to make investments in securities issued or sold by other banks in its correspondent system in order to enhance the bank's role as correspondent to smaller banks. If bank holding companies are permitted to sponsor mutual funds, the legislation should amend Section 17 of the Investment Company Act to prohibit a mutual fund sponsored by a bank holding company from purchasing securities issued or sold by other banks in the affiliated bank's correspondent system, with the SEC given the authority to issue individual exemptive orders and to adopt general exemptive rules in appropriate situations.

5. Conflicts of Interest Involving Sales Practices

Chairman Volcker has suggested a number of provisions designed to address conflicts of interest which are likely to arise in connection with the sale of the shares of mutual funds sponsored by bank holding companies. In 1981, he stated "that use of the bank's name be prohibited" and "that sales commissions not be charged."*/ In 1984, he stated that "It may also be desirable to require that the officers and employees of a securities affiliate or investment company advisor be separate from those that operate an affiliated bank, and that information on the financial activities of the bank's customers not be made available to the securities affiliate and vice versa."**/

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*/ 1981 Hearings, at 466.

Q.4. At the hearing on January 23, 1987, I asked you whether the Securities Act, the Securities Exchange Act, and the pervasive regulation of investment companies under the Investment Company Act would be sufficient to prevent the abuses of the 1920s from recurring. You replied that they would be insufficient, but you provided no specific examples. Apart from any deficiencies of the Investment Company Act described in response to the preceding question, how are current statutes and regulations insufficient to prevent abuses? Be as specific as possible.

A. The Securities Act of 1933 is designed to provide potential investors with full and fair disclosure regarding securities being offered to the public, but not to prohibit self-dealing and conflict of interest transactions involving the issuer of such securities and the issuer's affiliates. Congress recognized that the Securities Act was not adequate to deal with the unique structural and operational problems posed by pooled investment funds. Just seven years after the passage of the Securities Act Congress enacted the Investment Company Act which regulates the structure and day-to-day operations of mutual funds and other

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**/ 1984 Hearings, Part III, at 1610.

pooled investment vehicles investing in securities. Unfortunately, Congress did not draft the Investment Company Act so as to encompass all forms of pooled investment vehicles. The sorry story of bank-sponsored real estate investment trusts in the early 1970s demonstrates that the disclosure system of the Securities Act is not adequate to prevent a recurrence of the abuses of the 1920s.*/

The Securities and Exchange Act of 1934 regulates the activities of brokers and dealers which offer securities to the public, but like the Securities Act, it does not purport to regulate the operations of pooled investment vehicles whose shares are being offered to the public. Moreover, the Court of Appeals for the District of Columbia recently struck down the SEC's efforts to make the 1934 Act applicable to banks which sell securities to the public. There is a clear need for Congress either to close the regulatory loophole which permits banks to engage in brokerage activities or to amend the 1934 Act so as to make it applicable to banks.

The Investment Advisers Act of 1940 establishes a disclosure and regulatory system for those persons who render investment advice to the public. Prior to 1970, the Act exempted investment advisers whose only clients were mutual funds. In that year, Congress amended the Act so as to encompass these advisers. As SEC Chairman Shad advised this Committee: "In doing this, Congress determined in 1970 that the prohibition or unrestricted performance fees which had been in the Act since 1940 should be applicable to advisers to investment companies."*/

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*/ Even though bank REIT activities were also subject to the general anti-fraud provisions of the federal securities laws, such provisions were inadequate to prevent abuse. This highlights the need for specific regulatory controls, as pointed out in our response to Question 2.

However, the Act still exempts banks and bank holding companies. As Chairman Shad noted, the result is that banks and bank holding companies (unlike all other investment advisers to mutual funds) are not subject to the Act's limitations on performance fees or to Section 206 of the Act and the rules thereunder prohibiting fraudulent transactions. Chairman Shad has urged that the Advisers Act be amended to correct this situation,**/ and we concur. To date, none of the bills which would permit banks or bank holding companies to enter the mutual fund business would close this loophole.

Q.5. On page 18 of your written statement, you refer to a 1984 study of what would occur "if the top 20 bank holders of equity securities were to acquire the top 20 mutual fund advisory organizations"? Please list the 20 mutual fund advisory organizations included in your study.

A. Background documents which contain the names of the top 20 mutual fund advisory organizations are contained in closed files. We will furnish this information as quickly as these files can be retrieved or the information can be reconstructed.

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*/ 1981 Hearings, at 923.

**/ Ibid, at 924.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM DAVID SILVER

Q.1. *Your testimony repeatedly mentions potential conflicts of interest and tie-in arrangements associated with banks offering mutual funds to their customers. Yet mutual funds today are clamoring to sell their funds through banks and bank promotions. Banks are presumably paid fees to provide this service to customers. Do these circumstances give rise to similar potential conflicts of interest and tie-ins? If not, why not? If so, should the practice be prohibited*?

A. As discussed above, conflicts of interest and tie-in arrangements generally have arisen out of a bank's roles as both commercial lender and as the sponsor, adviser and underwriter of its own mutual funds. It would seem logical that these problems are less intense where a bank simply serves as a broker in connection with the offering of the shares of *unaffiliated* mutual funds to the public. In this situation, the bank cannot control or influence the fund's investment decisions and therefore has little motive to abuse its commercial lending relationships. Moreover, in this situation, the bank simply receives fees in connection with the offering of the shares of an *unrelated* fund, but does not receive management fees from the fund.

Various bank and bank holding company services in connection with the offering of mutual fund shares to the public are based on relatively recent rulings by the bank regulatory agencies.*/ We are not aware of any studies indicating that conflicts of interest and tie-in arrangements are taking place in connection with these activities. If such abuses are occurring, we would support the enactment of remedial legislation. As noted above, we also support legislation which would make it clear that banks which provide general brokerage services must register as broker-dealers under the Securities Exchange Act of 1934.

Q.2. Your testimony states that an immediate result of granting mutual fund authority to banks is that these institutions will gobble up and concentrate the mutual fund industry. You imply that the mutual fund industry is currently a widely dispersed group of independent "mom-and-pop" operations that would be defenseless in the face of bank capital. But isn't it true that the top ten mutual funds dominate over half the market; that eight of these are diversified financial service companies offering a range of activities prohibited to banks; and that 7 of the 8 have access to insured deposits through ownership of non-bank banks and thrifts? What percentage of mutual funds are owned by insurance companies. By non-financial firms? Why wouldn't banks provide more competition to this industry?

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*/ See letter dated May 23, 1986 from the Chief Counsel of the Comptroller of the Currency to the Director of the SEC Division of Investment Management, and letter dated June 27, 1986 from the General Counsel of the Federal Reserve Board to the Vice President of Sovran Investment Corporation.

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Garn -- Silver

A. At the end of 1986, approximately 53 percent of the total assets of all types of mutual funds were accounted for by the top ten mutual fund complexes. Our best estimate suggests that approximately 21 percent of total mutual fund assets are accounted for by complexes which are owned by insurance companies.

Our testimony was not intended to imply anything about the way in which the assets of mutual funds are dispersed. Rather, it was designed to emphasize that, while many financial industries are characterized by high degrees of concentration, the banking sector is unique. The point is not simply that the banking sector is big and highly concentrated. It is that these characteristics exist side by side with an array of activities which produce multiple relationships between banks and their customers. These multiple relationships bind customers to their banks and create a significant potential for conflicts of interest.

We respectfully submit that the proper inquiry is not the current level of concentration within the mutual fund industry or the current level of concentration within the banking industry, but is the increase in concentration which bank entry into the mutual fund industry would produce -- increased concentration in both the financial services industry and in the ownership of American industry by financial conglomerates.

A report prepared for the American Bankers Association specificallly concluded that it is only the nation's giant bank holding companies who are likely to enter the mutual fund business: "For the small community bank, fund management is not cost effective. A community bank cannot generate the critical mass, the break-even volume, that is required to profitably manage funds."*/ Moreover, it is likely that many large bank holding companies will enter the mutual fund business not by starting their own mutual funds, but by acquiring existing mutual fund organizations. The result will be increased concentration both within the mutual fund industry and in the ownership of the equities of individual companies and industries. This tendency towards increased concentration will not be subject to any countervailing competitive pressures. While bank holding companies would be empowered to enter the mutual fund business and to acquire existing mutual fund organizations, the nation's largest securities firms will not be allowed to enter the banking business since these firms engage in the underwriting of corporate securities.

The mutual fund industry presently is extremely competitive, with approximately 300 organizations sponsoring over 1,800 mutual funds.**/ We believe that bank entry into the mutual fund industry is likely to decrease competition as giant bank holding companies acquire existing mutual fund organizations and utilize the special privileges conferred on banks by government to gain market share.

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*/ Assessment of Business Expansion Opportunities for Banking, March 1983, at 243.

**/ The Wall Street Journal of February 12, 1987 quoted A. Michael Lipper of Lipper Analytical Services: "It is a very competitive industry.... Any group that looks like it is gaining assets will very quickly have 20 or 30 similar funds [in competition]."

Q.3. What is the ICI's position on non-bank banks? Do you support closing the "non-bank bank loophole"? If so, do you support divestiture by all companies that own non-bank banks? If not, how can you justify a mutual fund's access to insured deposits through ownership of non-bank banks if banks are not permitted access to mutual funds? Isn't one of the arguments against bank affiliation with mutual funds the unfair advantage accruing from access to insured deposits?

A. Please see our response to Senator Proxmire's first question.

Q.4. Should any check hold legislation that passes apply to mutual funds as well as depository institutions? Why or why not?

A. Check hold legislation should not apply to mutual funds. The banking industry, which has argued for applying such legislation to mutual funds, is misrepresenting the facts as well as the distinctions between bank accounts and mutual funds. First, mutual funds are not the perpetrators of check hold problems. All mutual fund-related checking is through bank issued checks. Bank check hold legislation should pro tanto reduce delays in mutual fund redemptions. Second, mutual fund shareholders have no complaints with respect to mutual fund check hold practices.

We are examining a full year of SEC complaint correspondence dealing with mutual fund redemptions. Thus far, we have not found a single complaint relating to mutual fund check holds. Mutual fund shareholders clearly understand the differences between mutual funds and ordinary bank checking accounts.

However, beyond these points, it might be helpful if we sketched the present investor protections and regulations which apply to mutual fund shareholders in this area.

Mutual funds are required by the Investment Company Act of 1940 to pay redemption proceeds to shareholders within seven days of receipt of a proper redemption order. The Securities and Exchange Commission has administratively permitted mutual funds to delay such mandatory redemption of shares when they are purchased by personal check in order to protect mutual fund shareholders from dilution of their assets by fraud. During the 1970s and 1980s mutual fund shareholders were victims of a series of fraudulent transactions whereby shares of a fund were purchased with a bad personal check and, relying on the delays involved in bank processing of checks, the writer of the check redeemed his or her shares (plus earnings) before the mutual fund was notified by the bank that the bank check was not good. The result was to dilute the value of the holdings of all of the shareholders of the fund.

It should be clearly understood that the effect of a bad check on mutual fund shareholders is very different from the effect of a bad check on bank depositors. In the case of a mutual fund, the loss on a bad check reduces directly and proportionately the value of each shareholder's holdings, whereas there is no such effect on bank checking account balances.

For these reasons, the application of check hold legislation to mutual funds is unnecessary and inappropriate. The Securities and Exchange Commission already regulates fund redemption procedures, including redemptions by checks. Subjecting mutual funds to the proposed legislation will expose all mutual fund shareholders to losses from fraudulent check-writing schemes. Because it is neither necessary nor fair to include mutual funds in the proposed legislation, we submit that they should not be included.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ALAN HEUER

Q.1. You stated on page 32 of your written statement that "CBA supports the financial services holding company concept developed by the Association of Bank Holding Companies as defined in its testimony here yesterday." The term "financial in nature" as defined in that Association's testimony would not, I believe, permit commercial firms with nonbank banks, such as General Motors, Chrysler, Sears, and J.C. Penney, to be included in financial services holding companies. Is that correct, or would the term "financial in nature" permit a financial services holding company to engage in manufacturing activities as well?

A.1 CBA's endorsement is of the overall diversified holding company concept, of which there are several models being developed. Our Association is interested in all variations on this theme, and we are hopeful that the Committee will at some point explore these proposals.

The question of ownership is central, but is still only one of the issues to be resolved. We do not foreclose proposals which go further than ABHC's. We will keep an open mind on the ultimate ownership of the financial services holding company until after the question has been adequately debated.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ALAN HEUER

Q. 1. In the last few years, several states have passed check hold legislation. The availability schedules that have been established under these laws have been tied to the actual time it takes for a check to be returned unpaid. What would be the potential losses to the banking system if the Federal Government mandated availability schedules shorter than the time it takes various types of checks to be returned unpaid?

A. 1. It is difficult to estimate losses to the banking system if legislated or regulatory mandated availability times were shorter than the actual time it takes for a financial institution to know whether or not an item will be paid. The fraud potential is enormous, however, because once those who want to take advantage of the schedule, understand how it works, they can begin systematic check "kiting" schemes.

Credit card fraud losses are a good example. Fraud losses in this area were relatively small until individuals and organized groups understood how they could counterfeit cards, or use discarded credit slips and other methods in order to illegally purchase goods and services. Unrealistic schedules will encourage similar fraudulent activities and losses.

Q. 2. Is it possible to be sufficiently precise about the check return technology that will be available over the next five or ten years to justify legislating availability schedules now?

A. 2. A mandated schedule based on current return times and necessary exceptions may be realistic today. When the technology improves, the availability time can be adjusted to reflect the improvements.

Q. 3. If mandated availability schedules were to expose banks to serious potential losses, what is the danger that depository institutions would stop offering checking accounts to the very people delayed-funds-availability legislation was intended to help? Do mandated and publicly available check hold schedules encourage fraud?

A. 3. Mandated schedules, not tied to actual return times, may well encourage fraud. (See answer to question 1.) It would be difficult to forecast whether or not institutions would stop offering checking accounts. However, if institutions begin to incur losses due to check fraud, it is not unlikely that they may be forced to become more selective in their standards for checking accounts.

Q. 4. Why is public disclosure of individual institutions' availability schedules not sufficient to protect consumers from unreasonable holds?

A. **4. We believe that public disclosure of an institution's availability schedule is sufficient and protects consumers from unreasonable holds. Consumers can compare hold periods and decide where to deposit their money. Public knowledge of availability schedules will also encourage institutions to make funds available within a reasonable time frame. Institutions need customers and will design their products and services to attract consumers. They must also consider safety and soundness when they design their products. Mandated schedules - not based on actual check return timetables - interfere with safety and soundness considerations.**

Q. 5. One argument that has been advanced for mandating shorter availability schedules relates to the fact that banks often receive provisional credit for checks being collected before the banks make the funds available to their customers. As soon as the banks receive provisional credit, they can begin earning interest on the funds, but if consumers have deposited the checks in demand deposits, they must wait until the end of the availability schedule before investing in interest-earning assets. With the increasing use of now accounts, which pay interest on funds from the date of deposit, has the need for funds-availability legislation been reduced? Don't the vast majority of banks pay interest on deposited checks from the date of deposit or the date the bank receives professional credit?

A. **5. The vast majority of banks do pay interest on deposited checks from the date of deposit or the date of provisional credit. The receipt of provisional credit does not have any relation to whether or not a check will ultimately be paid. Using time frames for provisional credit to determine availability schedules is unrealistic and could encourage fraud.**

Q. 6. If a customer needs quick availability of his money, to what extent can wire transfers be substituted for check payments?

A. **6. Wire transfers are and can be substituted for check payments in a number of ways. As the electronic funds transfer (EFT) payments systems continue to evolve, more EFT transfers will occur. For example, point of sale (POS) transfers where consumers use a debit card instead of a check at a merchant's store, are increasing. Mortgage payments and other recurring obligations are being transferred electronically.**

Q. 7. If a consumer needs quick availability of his money, would it be reasonable to require the consumer to establish a credit line with his bank equal to the amount of credit he wants on check deposits before the expiration of the time it takes for those checks to be returned unpaid?

A. 7. **Requiring customers to establish a credit line equal to the amount of credit they want on deposited checks may be an expensive and an inefficient means for consumers to use their funds before they are actually available.**

Q. 8. For consumers, how do the average length of check holds with credit unions and savings and loans compare with that of commercial banks?

A. 8. **Often "check holds" at credit unions, thrifts and small commercial banks are longer than those established by larger commercial banks. This is due to the fact that their institutions must use a correspondent bank to clear their checks. In addition, clearing times also depend on the location and the technological development of the institution. These considerations, rather than the type of institution, result in longer clearing times and thus longer hold periods.**

Q. 9. Should check hold legislation apply to money market mutual funds as well as banks?

A. 9. **Yes.**

AARP

Statement

Of The

AMERICAN ASSOCIATION OF RETIRED PERSONS

Concerning

OMNIBUS BANKING LEGISLATION

Before the

Committee On

BANKING, HOUSING AND URBAN AFFAIRS

United States Senate

Submitted:
February 5, 1987

American Association of Retired Persons 1909 K Street, N.W., Washington, D.C. 20049 (202) 872-4700
John T. Denning *President* Cyril F. Brickfield *Executive Director*

The American Association of Retired Persons (AARP), a membership organization of more than 24.5 million Americans age 50 and above, respectfully submits for the record these comments concerning omnibus banking legislation.

At the onset, we express our appreciation to Chairman Proxmire and the members of the committee for recognizing the urgent need to address long overdue banking legislation early in the 100th Congress. AARP stands ready to assist the committee in the passage of legislation vital to all consumers, including older consumers.

AARP, like many others, wants to restore faith and confidence in the nation's financial services industry. To this end, we urge the committee to capitalize adequately the Federal Savings and Loan Insurance Corporation (FSLIC) and to provide emergency acquisitions authority for troubled institutions. Our comments, however, focus on other areas of significance to older Americans, including:

(1) Allowing for the existence of consumer banks, provided specific safety and soundness protections are incorporated;
(2) Linking any expanded banking powers in the securities area to direct consumer benefits;
(3) Mandating limits on check hold periods.

All of the above must be incorporated into any omnibus legislation that emerges from committee.

Consumer Banks. Congress must affirmatively allow for the existence of consumer banks, provided specific safety and soundness safeguards are enacted. Any attempt by Congress solely to close the non-bank bank loophole would fail to recognize (a) the role that should be played by adequately regulated consumer banks in the delivery of services to consumers, and (2) the competitive impact consumer banks would necessarily have upon traditional financial institutions. AARP, therefore, urges the committee to conduct additional hearings to discuss consumer bank provider concerns in this area.

For older consumers, consumer banks could provide access to basic banking services (fulfilling needs oftentimes overlooked by traditional institutions). Older consumers would also share the benefits of increased competition created by the presence of consumer banks.

In addition, closure of the non-bank bank loophole, coupled with the grandfathering of current non-banks, would not place consumer protections upon the non-banks currently in existence. The preferred approach is to place consumer protections upon the non-banks currently operating and to allow for the existence of new consumer banks which would also be subjected to these same consumer protections.

AARP believes consumer banks should be allowed to conduct business and provide services only if they: forego commercial business entirely; offer free checking on non-interest bearing accounts; require no more than a $25.00 initial deposit; make sure bank service charges and fees are only reasonable to offset administrative costs; give same day credit to all government, local checks and other checks of limited size; observe reasonable hold periods for all other checks; provide clear information on interest rates, compounding methods, fees, service charges, availability schedules; and obtain Federal Deposit Insurance Corporation coverage. Companies providing consumer bank services must be prohibited from: using bank funds for other business purposes, tying bank loans to the purchase of other goods and services offered by the company, exceeding reasonable antitrust limitations on market saturation. Consumer banks must also: meet the same or higher capital requirements as those imposed on traditional banks, reinvest reasonable amounts of their funds in the community where banking services are provided, and avoid conflicts of interest.

Expanded Securities Powers. AARP believes any expansion of banking powers must necessarily be coupled with direct consumer benefit. This is particularly true in the securities area given the recent United States Court of Appeals decision holding that the Securities and Exchange Commission (SEC) broker-dealer registration requirement does not extend to the activities of bankers engaged in the sale of securities. The SEC has not yet determined if it will appeal this decision. Before bankers are granted expanded powers in the securities area, we urge Congress to thoroughly examine and specifically delineate the parameters of this authority.

The SEC, with extensive expertise in the area, appears to be the logical federal agency to regulate all sales of securities, including those made by bankers. Delegation of this responsibility to the SEC, coupled with adequate funding to assure compliance, may well be the preferred approach.

However, in light of the court decision, this responsibility will probably devolve upon the federal banking regulators, who have little expertise in this area. In addition, the banking regulators continually assert they do not have adequate resources to accomplish the responsibilities with which they are presently charged. Indeed, community re-investment compliance is an area of rare enforcement. To now charge these agencies with increased responsibilities in the securites area, without increased funding, will probably mean that resources will be stretched even further.

Congress must assume responsibility for providing consumer protection in the securities area and must not allow the federal banking agencies to proceed without Congressional guidance. Therefore, before granting bankers expanded securities powers, the committee must thoroughly investigate with the SEC and the banking regulators the impact of this recent case, precisely who will regulate activities in this area, and what minimal consumer protections will be assured.

An important tool in dealing with this problem will not become available until late September, 1987 when the SEC is required to submit study findings to the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Energy and Commerce Committee concerning consumer abuses in the sale of securities. This report might prove instructive to the committee in addressing potential abuses that may occur as the result of banker involvement in the securities area.

The interest of older consumers in the securities area is apparent. Since many older persons invest in securities, they stand to lose a great deal--possibly their life savings--at the hands of incompetent or unqualified investment advisors. Therefore, quality must be assured while consumer redress is guaranteed.

Check Holds. AARP urges passage of strong check hold legislation immediately. Since consumers desperately need protection from abusive and unreasonable check holds, it is imperative that check holds legislation be given priority status this Congress.

AARP supported H.R. 2443 (which mandated availability schedules) in the House during the last Congress, and was disappointed by the failure of the Senate to pass similar legislation. We are pleased Senator Dodd has strengthened and improved his original legislation, and support the basic concepts contained in S. 344. This legislation, while delegating responsibility to the Federal Reserve Board for devising funds availability schedules, sets forth perameters under which the Fed must respond. We do not, however, support any broad delegation of authority in this area to the Fed.

Holds are placed on all types of checks--government, local and out of state. The result is that persons who require timely access to their funds experience hardship, frustration and monetary loss. While this is true for all consumers, it is particularly true for lower income, elderly consumers who must rely upon timely access to their funds to meet basic living expenses--food, shelter, utility and other bills. It is simply unfair for restrictive check hold practices to deny such individuals timely access to their own money.

Check holds are prevalent and limits have widespread support. In a nationwide AARP survey conducted in December 1985, one in every four individuals reported that banks currently hold their checks. A majority of those polled felt that current hold practices are unreasonable. Over three in five favored limiting the number of days a bank can hold a check.

AARP member mail also demonstrates elderly concern over check holds. In recent months, AARP has received hundreds of letters from across the country supporting the need for federally mandated funds availability schedules. These complaints range from the holding of a Social Security check to denial of access to deposited dividend funds.

AARP, therefore, urges the committee to assure consumers protection in this area through swift passage of strong check hold legislation.

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William M. Crozier, Jr.
Chairman of the Board and President

BayBanks

January 26, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Proxmire:

Your position with regard to closing the non-bank bank loophole in the Bank Holding Company Act and imposing operating restrictions upon any such institutions that might be grandfathered by future legislation is one which BayBanks vigorously supports as a matter of competitive equity. Early last fall I met with Ken McLean and discussed with him our concerns about non-bank banks. Now, in light of the Senate Banking Committee hearings on this issue and our understanding that you and your staff are particularly interested in receiving industry views on the types of activity restrictions or other operating controls that should be imposed on non-bank banks, we take this opportunity to present our recommendations for your consideration.

BayBanks, Inc. is a multi-bank holding company which owns eight commercial banks located in Massachusetts with combined deposits at year-end of $6.3 billion. Our banks operate over 200 offices in Massachusetts serving both consumers and businesses. The Company, which has assets of $7.6 billion, faces competition locally from such financial services giants as American Express (operating through its local subsidiary non-bank bank the Boston Safe Deposit and Trust Company) and from another half dozen or so non-bank banks operated by securities and insurance firms, many of national stature.

We have lobbied aggressively at both the state and federal level over the last several years to close the non-bank bank loophole; in fact we drafted a Massachusetts bill to this end which now faces its second year in front of the state legislature. Several state legislators with whom we have met cite inaction at the Federal level as one reason to defer movement on the non-bank bank issue here. Whatever action you and your Committee can take to control and stabilize the competitive inequities created by non-bank banks will be a great service to the banking industry.

We believe that the four principal actions to be addressed by federal non-bank bank legislation are:

(1) Closing the loophole

(2) Prohibiting the cross-marketing of services by any grandfathered non-bank banks and their affiliates

(3) Prohibiting geographic or product expansion by any grandfathered non-bank banks

(4) Requiring that the owners of any grandfathered non-bank banks be regulated as bank holding companies under the Bank Holding Company Act

Closing the Loophole

Although BayBanks strongly supports strict divestiture of all non-bank banks, we recognize that the process of legislative compromise is likely to result in a grandfather date applicable to some existing institutions. We support as early a grandfather date as possible in recognition of the widespread and prominent notice given by both Congress and federal banking regulators several years ago to the effect that the non-bank bank loophole was an issue of considerable concern and that those contemplating using it to their own advantage might well be forced to divest at a later date.

Prohibiting Cross Marketing of Services

We believe that legislative restrictions should prevent any grandfathered non-bank banks from operating in tandem with their unregulated, diversified parent companies so that they have a competitive advantage over regulated, non-diversified banking companies, i.e.,

- Grandfathered non-bank banks should be prohibited from offering or marketing those products or services of their affiliates, or parent company, that by law or regulation may not be offered or marketed by bank holding companies, their non-banking subsidiaries, or their subsidiary banks.

- Non-bank bank affiliates, or their parent companies, that are engaged in businesses proscribed for bank holding companies should not be permitted to offer or market the products or services of the non-bank bank, or to offer or market any of their own products or services at the same location as the non-bank bank.

Prohibiting Geographic and Product Expansion

Grandfathered non-bank banks should be prevented from establishing a greater presence than they now have in the banking business. The activities and locations of such institutions should be limited to those engaged in, or in existence on, the grandfather date.

Regulation of Owners of Non-Bank Banks

The owners of any grandfathered non-bank banks should be subject to the same oversight as bank holding companies and should be required to register with the Federal Reserve Board, regardless of whether the non-bank bank is state chartered or federally chartered.

We believe that the owners of non-bank banks, especially those that accept insured deposits and have access to the payments system, should be supervised by the Federal Reserve Board as a matter of competitive equity and risk control. We share with Federal Reserve Board Chairman Volcker his concerns about use of the payments system by diversified, non-regulated companies permitted direct access through non-bank banks under their control. Federal Reserve oversight of such companies, as proposed here, might be one effective step in addressing some of the payments system issues.

Another oversight issue of great importance to us, but perhaps less well recognized, is that involving the owners of state-chartered, FDIC insured savings banks that are stock institutions. These "banks" presently offer a potential remaining legal loophole allowing diversified non-banking companies to escape the provisions of federal non-bank bank legislation. In Massachusetts, as in many other states, these institutions have been granted all of the powers of commercial banks. We believe that if these institutions are acquired, or otherwise operated by a holding company, their owners should be regulated as bank holding companies under the Bank Holding Company Act (12 U.S.C. § 1841 *et seq.*) rather than as thrift holding companies as has been proposed by some. Any other form of regulation would be inconsistent with the principles of competitive equity; firms owning depository institutions that are *de facto* commercial banks should be regulated as commercial bank holding companies.

Legislation containing the foregoing types of restrictions would preserve the balance of competition in the financial services industry until such time as Congress decides that further financial deregulation is necessary or appropriate and authorizes additional powers for all financial services institutions on an equitable basis subject to common forms of supervision.

We request that this letter be included in the record of the Senate Banking Committee's hearings on non-bank banks and offer our assistance to you and your staff in any way that would be helpful as you proceed with non-bank bank legislation. We appreciate this opportunity to present our views and welcome your leadership in resolving this most troubling situation.

Sincerely,

Bill Crozier

William M. Crozier, Jr.
Chairman of the Board
and President

/mbl

cc: Paul A. Volcker
Kenneth A. McLean

GENE LaFRANCE

G. JACK HILLSTROM

INDEPENDENT BANKERS OF MINNESOTA

7850 Metro Parkway • Suite 211
Bloomington, Minnesota 55420 (612) 854-9200

January 29, 1987

The Honorable William Proxmire
United States Senator
Senate Banking Committee
530 Dirksen Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

I commenced to draft the enclosed press release after watching your January 21st Committee hearings on C-Span.

You and the members of your Committee were not provided frank, factual answers from the witnesses and, in my opinion, that is discourteous and inexcusable.

Comptroller Clark danced around your question about his department giving aid to those seeking banking law loopholes. The fact is, he had no problem issuing banking licenses in the District of Columbia recently by dredging up a law that's older than I am.

Chairman Seidman, on the other hand, complained of having to cope with a new law that is "thirty six years old". He'd love it if it opened up another border to interstate banking of course.

Secretary Baker responded to the suggestion that some foreign loans should be written down to reflect their true market value as "playing games" and said he didn't want any part of it. Would he, as spokesman for the Administration, like to apply that same generous rule to our nation's rural and energy banks?

I seem to recall a rather inflexible policy applied to them that made the writing down of non-performing loans part of the game, if you will.

Chairman Volcker attempted to sidestep Senator Sasser's inquiry as to how appealing expanded powers were to independent community banks by saying the regional banks were really quite enthusiastic about these powers. The Senator was correct in guessing there was virtually no enthusiasm for expanded powers. They simply want the non-bank-bank loophole closed once and for all.

Senator William Proxmire
Letter of 1/29/87
Page 2

Finally, Chairman Volcker responded to Senator Gramm's suggestion that "fact replace fiction" in the case of the Third World debt in a questionable manner. Senator Gramm along with every member of your committee has heard enough factual information from reliable sources to know that all is not well with our Third World debt situation. We hope a remedy can be found, but if not the consequences will be bad, as I'm sure you realize. At that point, fingers will be pointed in every direction. Not many will readily accept the excuse that "the regulators didn't want to talk about it".

Keep the pressure on until your questions are answered to your satisfaction.

I hope you see fit to include my press release in the record of your January 21st hearings.

Best regards,

(Norb)

Norbert A. McCrady
Executive Vice President
For Independent Bankers of Minnesota

NAM:me

Encl. Press Release

cc: Ken McLean, Staff Director

President [illegible] 1st Vice President [illegible] 2nd Vice President [illegible]

INDEPENDENT BANKERS
OF MINNESOTA

7850 Metro Parkway • Suite 211
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NORBERT A. McCRADY [illegible]

PRESS RELEASE

LET THE DIALOGUE COMMENCE

JANUARY 30, 1987

Little by little more basic truths are surfacing about the banking industry in the United States. As the story unravels, it captures the attention of more and more people who understand why the story must come out before further damage is done.

Angry reactions by highly placed officials do more to reveal the embarrassing state of affairs than to convince the inquisitor that "all is well."

This is not to say the plug should be pulled but it is time we discuss facts, not fiction.

The January 21st appearances by Federal Reserve Chairman Volcker, FDIC Chairman Seidman, Comptroller Clark and Treasury Secretary Baker before the Senate Banking Committee may have succeeded in comforting the unsophisticated observer but most who watched were not impressed.

Before the credibility of our entire federal banking regulatory structure is reduced to ridicule, inquisitors of standing such as members of the Congress must be provided honest and straightforward answers to the justifiable concerns they ask about.

Protecting certain institutions from harm can only be justified to the extent that it is being done to protect the public interest. In the case of defaults in loans to Third World nations it is time to quit pretending.

It is not healthy, accurate nor justifiable from the public interest standpoint to continue the facade that has created confusion at the expense of trust and confidence in our banking system.

The true market value of Third World debt owed the largest international banking corporations of the United States barely exceeds 50% of what these banks are carrying these obligations on their books.

If it could be shown that this condition, involving hundreds of billions of dollars, was only temporary and that a solution was near at hand, there might be some reason to let the process take its course. The fact is that no one with even the slightest professional understanding of the situation believes the situation is temporary or that a solution is near at hand. Members of Congress have every right to expect complete openness from regulators as to the seriousness of the problems and the remedial steps being taken to eliminate them.

Those who closely follow crises such as this are not unaware of the means by which these international lenders continue to carry these loans as unclassified, performing debt obligations. Any attempt to cover the trail of U.S. Treasury contributions to the I.M.F. and thence on to the debtor nations where it is used to service the interest owed our nation's international banks has been and will continue to be futile.

No solution to this problem will be simple or painless but more importantly, regulators must first admit the problem exists before serious discussions about a solution can even commence. While this seriously deteriorated Third World debt obligation is allowed to appear virtually at face (full) value, our nation's agriculture and energy sectors are suffering under an entirely separate and discriminatory policy.

Energy and ag bankers are having their non-performing loans classified and are forced to "cough up or cash out." No leniency here. These energy and ag banks got in trouble trying to finance the needs of U.S. businesses, farmers, and citizens in general. When the economic downturn hit the energy and ag sectors in our nation, these banks hung in there with their customers and communities, knowing they represented the only hope for many throughout the nation.

The international politics of currency valuations between nations kept the value of the dollar higher than our own production of commodities and materials could cope with. It is a widely held belief among international observers that a principal reason for holding the dollar so high was to enable the Third World debtor nations to benefit in the marketing of their own exports. This, in turn, was intended to earn sufficient profits for these nations to service their debt to U.S. banks.

The victims were many, foremost of which was our own energy sector and the producers of our nation's agriculture commodities.

We can ill afford to allow a few highly placed regulators to fend off questions from responsible members of the Congress who are rightfully alarmed at the gravity of the situation. During the January 21st hearings of the Senate Banking Committee, responses from the federal regulators and from the Treasury Secretary to questions from committee members Bramm, Heinz, Riegle and Sasser for instance were sometimes defensive, sometimes misleading and, in most cases, "slanted."

Unless the Congress succeeds in getting straight answers to their questions, the next alternative is to call for a full scale Congressional Inquiry in order to get the facts on the table. Facts—-not fiction.

And in the meantime these international banks must be rated according to their condition "after taking into consideration any impairment of their capital resulting from the deterioration of market value of debt obligations, whether foreign or domestic."

It would be contrary to any interpretation of the safety and soundness doctrine to permit any such banking institutions to broaden their scope through mergers, acquisitions, de novo chartering, detaching, branching, going interstate or expanding into other fields including brokerage, insurance, municipal bonds or other forms of commerce.

Let the dialogue commence. It has been stifled long enough.

STATEMENT SUBMITTED ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE SAVINGS & LOAN SUPERVISORS TO THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS. THE COMMITTEE IS HOLDING OVERSIGHT HEARINGS TO REVIEW THE STRUCTURE OF THE FINANCIAL INSTITUTIONS SYSTEM, FOCUSING ON THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION RECAPITALIZATION, EMERGENCY BANK ACQUISITIONS, NONBANK BANKS, SECURITIES POWERS FOR BANK HOLDING COMPANIES AND BANK CHECK HOLDS.

JANUARY 21-23, 1987

Mr. Chairman and members of this distinguished Committee, my name is George C. King. I am President of the National Association of State Savings & Loan Supervisors ("NASS&LS"). Our association appreciates your deep concern with respect to the current status of the savings and loan industry and commends you for attempting to address these concerns and conducting these hearings.

NASS&LS very much appreciates the opportunity to present its views to this distinguished Committee. As the representative body of the state regulatory arm of our dual system of supervision and regulation with respect to the savings industry, the members of NASS&LS are the state officials who oversee the operations of state-chartered savings institutions in the 50 states. The members of NASS&LS supervise and examine approximately 1500 state-chartered savings institutions with assets of approximately $400 billion. For almost twenty years, the members of NASS&LS have been actively involved with the protection of the consumers' interest in equitable and available home financing. The dramatic changes which have occurred in the savings industry in recent years has heightened NASS&LS' commitment to the overriding principal of safe and sound operation of savings institutions. The protection and perpetuation of state-chartered savings institutions is uniquely the purview of the various states. Acknowledging that NASS&LS' concern for a sound system of savings institutions is validly shared by national legislators and regulators, NASS&LS nonetheless believes that the various states are better positioned to determine what is most needed by and in the best interests of their constituents. This belief has historically been fostered and embraced as the fundamental basis of our dual system of chartering, supervision and examination of financial institutions.

NASS&LS wishes to specifically comment on a provision that was added to the Financial Institutions Equity Act of 1985 (H.R. 20) without benefit of any hearings or deliberation. NASS&LS very strongly opposes this provision which is found in the bill's savings and loan association section which authorizes the Federal Home Loan Bank Board ("Bank Board") to prescribe rules prohibiting savings institutions from engaging in any activity that the Bank Board considers an "improper incident" to the operations of institutions the accounts of which are insured by the Federal Savings and Loan Insurance Corporation. The authority that would be conferred on the Bank Board by this language far exceeds any previous grant of authority by the Congress.

Substituting an "improper incident" criterion for the "safety and soundness" criterion dramatically alters the historical balance between state and federal supervision and regulation of the savings industry. The bill further stated that no activity which was permitted to a federally-chartered savings institution pursuant to Section 5 of the Home Owners Loan Act of 1933 would be considered an "improper incident". For Congress to enact language of this nature would be to effectively federalize the savings industry. To grant authority to determine what activities would be considered an "improper incident" solely to the Bank Board and to further delineate that a safe harbor of activities are those granted to federally-chartered savings institutions would surely do grave harm to our dual system of supervision and regulation. In effect, the sovereign right of the states to determine the proper activities of state-chartered savings institutions would be eliminated. Time after time, as Congress has conferred new and expanded authority on the Bank Board, it has stressed its intent to preserve the dual system of financial institution regulation and the importance of the states' role in regulating state-chartered institutions.

NASS&LS would like to reiterate its general support for the Bank Board and the Bank Board's overriding concern for the safety and soundness of the savings industry. NASS&LS is second to none in its vigil to ensure that the participants in the savings industry conduct themselves in a safe and sound manner. However, to adopt language giving the Bank Board the sweeping discretion contained in the savings and loan provisions of H.R.20 assures that in a short time the states would play no role whatsoever in the determination of what constitutes acceptable business activity for state-chartered savings institutions.

This provision of the bill would permit the Bank Board to override state law. The dual system of financial institution supervision and regulation and choice of chartering authority has been the lifeblood and vitality of competition within the nation's financial institution system. State authority over the powers of state-chartered institutions has added a healthy degree of flexibility to our system of savings institutions. Preemption of state authority weakens the system as a whole.

NASS&LS would like to again thank the members of this Committee for the opportunity to present its views and to extend an offer of assistance to the Committee in whatever way possible.

February 6, 1987

Honorable William Proxmire, Chairman
Senate Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Proxmire:

We very much appreciated the opportunity to testify before your Committee on the need for funds availability legislation on January 23. We are writing to clarify our response to a question you posed at that hearing and we request that this letter be included in the hearing record. You asked whether check hold time limits should be specified in law by Congress or in regulation by the Federal Reserve Board.

As we stated in our testimony, both oral and written, the basic scheme we endorse is 1-3 day availability with specific exceptions where a bank may be at risk. This schedule could be accomplished in one of two ways. Congress could set forth the schedule by statute. In the alternative, Congress could mandate by statute an outside limit of 3-day availability and direct the Federal Reserve Board to tier the schedule to equal the periods required for depository institutions to receive provisional credit for particular categories of checks.

We wanted to be sure that members of the Committee understand that we oppose any open-ended delegation to the Federal Reserve Board and prefer a schedule of 1-3 days established in the statute itself or by other statutory means, as described above, that achieve the same result.

We hope this answers your specific question, and would be happy to answer questions on what further provisions a holds bill should include.

Sincerely,

Franci Livingston
Franci Livingston
Staff Attorney
Public Citizen's Congress Watch

Michelle Meier
Michelle Meier
Counsel for Government
Affairs
Consumers Union

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Burton C. Wood
Senior Staff Vice President
and Legislative Counsel
202-861-6507

January 20, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is submitted with respect to hearings the Senate Banking Committee is conducting that relate to recently introduced financial institutions legislation. The Mortgage Bankers Association of America respectfully requests that this letter be included in the official hearing record in connection with the Committee's hearings on these matters.

MBA supports provisions found in S 60, the "Financial Services Competitive Enhancement Act," introduced by Senator Jake Garn (R-UT), Ranking Minority Member of the Senate Banking Committee, that would grant bank and thrift institutions expanded securities powers. In particular, MBA strongly supports the authorization of these financial institutions to underwrite and deal in private mortgage-backed securities (MBSs).

The importance of the secondary mortgage market in improving the flow of funds to the housing sector has been recognized by Congress, which has encouraged the growth of securities guaranteed by Federally sponsored enterprises, such as the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC). Banks and thrift institutions are currently able to underwrite and deal in MBSs guaranteed by these Federally related entities. However, they are not permitted to underwrite and deal in privately issued MBSs, even though these financial institutions are significant originators of both residential and commercial real estate loans, and invest in significant amounts of MBSs for their own portfolios.

Permitting banks and thrifts to underwrite and deal in privately issued MBSs would significantly increase the number of competitors in the market, leading to lower underwriting costs, lower interest rates for homebuyers, and greater liquidity in the secondary mortgage market. Increased efficiency in this marketplace will also ensure that mortgage money is available across the nation. The result would be lower costs and increased availability of funds for homebuyers.

While the dollar volume of private issues is small compared to that of issues backed by GNMA, FNMA, and FHLMC, the market has significant growth potential. Congress has contributed to this growth potential with the enactment of the Secondary Mortgage Market Enhancement Act of 1984 (P.L. 98-440), and, more recently, with the inclusion of the Real Estate Mortgage Investment Conduit (REMIC) provisions in the recently adopted Tax Reform Act of 1986 (P.L. 99-514). Legislative innovations such as these will widen the secondary mortgage market and increase the liquidity of MBSs, while lowering mortgage interest rates for homebuyers. In light of recent Congressional activity in this area, MBA respectfully urges Congress to continue its support for housing and the secondary mortgage marketplace by enacting legislation that would allow banks and thrifts to underwrite and deal in MBSs.

We would be pleased to furnish any additional needed information by you or the Members of the Committee. Thank you for your courtesy in this matter.

Sincerely,

Burton C. Wood

Burton C. Wood

STATEMENT OF

ROGER W. JEPSEN

CHAIRMAN

NATIONAL CREDIT UNION ADMINISTRATION BOARD

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

JANUARY 22, 1987

Mr. Chairman and Members of the Committee, I am pleased to submit this statement for the record on behalf of the National Credit Union Administration. You have asked our Agency to comment on your proposed legislative package which may extend to such issues as FSLIC recapitalization, crisis merger powers for regulators, and other issues.

Mr. Chairman, as your legislative plans for this session attest, your Committee is and will continue to be, structured towards a comprehensive and far reaching examination of today's financial marketplace. Credit unions are and will continue to be vital components of this marketplace. Statistics compiled by NCUA show that growth has been continous throughout the 1980s for both state and federally-chartered credit unions. Increases in credit union shares, share certificates, IRAs and assets all constitute aspects of this growth. Likewise, more credit unions are participating in real estate and business lending. In brief, at a time when the number of bank failures is at its highest and the thrift industry is in a state of flux, the credit union community is thriving.

Your proposed legislative package contemplates numerous modifications in the financial system; however, few if any changes are being considered for credit unions. NCUA agrees that few changes should be made to the basically sound credit union operational and regulatory environment. We are most pleased that the legislative proposals the Committee intends to consider support this conclusion.

I am particularly pleased that your hearings are addressing the issue of crisis merger powers for the banking regulators. You'll recall that legislation with this purpose, commonly referred to as "The Regulator's Bill," was offered last year. This legislation included a section extending Titles I and II of the Garn-St Germain Act of 1982. NCUA's conservatorship authority is provided for in Title I of this Act.

Congress was unable to pass this legislation last year. Despite four short-term extensions, NCUA was left without its conservatorship authority when the last of these extensions expired on October 13, 1986. It is my understanding that there was general agreement the authority should be extended, even made permanent, but that last minute problems, involving other issues, made that impossible.

NCUA is hopeful that this legislation will be addressed by both the Senate and the House early this session. While we seek to have this authority made permanent, we would certainly welcome the extension provided for in the merger legislation. For our immediate purposes, however, we encourage you to consider at least a short-term extension of this authority.

NCUA's conservatorship authority was granted, on a temporary three year basis, by the Garn-St Germain Act of 1982. It has been a most effective administrative tool for the NCUA Board in better ensuring the safety and soundness of credit unions. It has remedial aspects not found in other forms of Agency action. It permits the Agency to freeze an institution in the position it finds it upon the imposition of conservatorship and thereby prevents a dissipation of assets that could have a substantial adverse effect on that credit union's members, creditors, and the National Credit Union Share Insurance Fund (NCUSIF). It has particular value and importance where publicity about a credit union's soundness may trigger substantial share withdrawals and thus endanger the credit union's deposit base and the soundness of the institution in general.

Conservatorship has other benefits. In some cases, obtaining control of a credit union's operations and assets has precluded its officials, suspected of self-dealing and other questionable activities, from tampering with or destroying records of their activities, thereby preserving evidence where criminal activity was suspected.

It is also beneficial where the true causes of a credit union's problems, and thus the appropriate remedy, are not easily ascertainable. If problems are not sufficient to warrant liquidation, it allows the NCUA Board the flexibility to work with credit union personnel to reopen the institution while at the same time preserving its integrity. This is accomplished by controlling the impact of outside influences which could otherwise seriously impair its viability. Liquidations may sometimes be inevitable but the value of the credit union may have been preserved, or losses reduced, for the benefit of all concerned, by using conservatorship.

Since the conservatorship authority was granted it has been used in twenty cases. To date, we estimate that savings for the NCUSIF total more than $43.8 million.

Mr. Chairman, I urge you to support legislation which would extend this authority. I also urge you to consider legislation to make this authority permanent so that we will be able, without interruption, to implement this important and essential protection for the Share Insurance Fund.

Mr. Chairman, attached is a copy of the credit union community's legislative package for 1987. This package emphasizes my earlier point that few changes are required in the credit union operational and regulatory environment. Compiled by the Agency and the two major credit union trade associations, this package consists only of a number of supervisory amendments to the Federal Credit Union Act. In fact, four of these amendments relate to the Agency's just discussed conservatorship authority. One of these amendments would make this authority permanent. I hope that you consider these amendments when compiling your comprehensive banking legislation. My staff and I are more than willing to further discuss this package with you.

Finally, Mr. Chairman, I note with pleasure that a Member of your Committee, Senator Riegle, has introduced legislation identical to Representative Carper's "Depository Examination Improvement Act of 1987" (HR 545). NCUA supported this legislation last year and will certainly support it again this Congress.

This concludes my statement. I thank the Committee for the opportunity to submit these comments.

PROPOSED AMENDMENTS TO THE FEDERAL CREDIT UNION ACT
1987

1. Permanent Conservatorship Authority

"Strike Section 141(a)(8) of Public Law 97-320. The provisions of sections 131 and 132 of Public Law 97-320 are in full and continuing effect upon enactment of this section."

This amendment eliminates the sunset provisions from NCUA's conservatorship and emergency merger authorities. During its four year "trial period," conservatorship has proven to be an effective supervisory tool for NCUA. More than $43 million has been saved for the Share Insurance Fund.

2. Additional Amendments Pertaining to Conservatorhip Authority

- Reduce Waiting Period for State's Comments on Conservatorship Action from 90 to 30 days.

"Section 206(h)(2)(B) of the Federal Credit Union Act (12 U.S.C. 1786(h)(2)(B)) is amended by striking the word 'ninety' and inserting in lieu thereof the word 'thirty.'"

Events today often compel quick and decisive action by regulators such as NCUA. Ninety days is an excessively long period of time during which the goal of "conserving" the credit union assets could well be subverted.

- Additional Grounds for Imposition of Conservatorship.

"Section 206(h)(1) is amended by deleting the "or" at the end of subparagraph (A), deleting the "." at the end of subparagraph (B) and inserting a ";" in lieu thereof and by adding the following:

> '(C) there is a willful violation of a cease and desist order which has become final; or
>
> (D) there is concealment of books, papers, records, or assets of the credit union or refusal to submit books, papers, records, or affairs of the credit union for inspection to any examiner or to any lawful agent of the Board.'"

These two additional bases for imposing conservatorship will enable NCUA to move quickly when a cease-and desist order is violated and when reliable financial data cannot be obtained.

- Clarify NCUA's Authority as Conservator.

"Section 206(h) is amended by adding the following new subsection (8), and by renumbering the present subsection (8) as (9).

> 'The conservator shall have all the powers of the members, the directors, the officers, and committees of the credit union and shall be authorized to operate the credit union in its own name or to conserve its assets in the manner and to the extent authorized by the Board.'"

Expressly states NCUA's authority under a conservatorship order.

3. NCUA's Status as Independent Agency.

"Section 120(i)(1) of the Federal Credit Union Act (12 U.S.C. 1766(i)(1)) is amended to read as follows (new language underlined):

> '(i) In addition to the authority conferred upon it by other sections of this Act, the Board is authorized in carrying out its functions under this Act--
>
> (1) to appoint such personnel, without regard to the provisions of other laws applicable to officers or employees of the United States, as may be necessary to enable the Administration to carry out its functions, and determine their compensation, leave, and expenses, governed solely by the provisions of this Act and the rules and regulations of the Board not inconsistent therewith;'"

Grants NCUA independence from OPM with respect to areas such as selection and placement of employees and the provision of job-related benefits.

4. Added Flexibility of NCUA

> "Section 120(i)(2) of the Federal Credit Union Act (12 U.S.C. 1766(i)(2)) is amended by inserting after 'reimbursement,' the language 'acquire and dispose of, by lease or purchase, real or personal property, without regard to the provisions of any other law applicable to

executive or independent agencies of the United States,' and by inserting after the word 'Act' a comma (",") and adding the language 'in accordance with the Rules and Regulations or policies established by the Board not inconsistent with this Act;'"

This amendment is designed to provide the NCUA Board with needed flexibility to obtain office space and equipment, the nature and location of which would be determined solely by the needs of the Agency.

5. Amendments Expanding and Enlarging NCUA's Removal and Prohibition Authority.

o Section 206(g) of the Federal Credit Union Act (12 U.S.C. 1786(g)) is amended as follows:

(1) in paragraph (1) by striking 'director, officer, or committee member' each time it appears and substituting in its place 'director, officer, committee member, or employee;'

(2) in paragraph (2) by striking 'director, officer or committee member' the first two times it appears and substituting in its place 'director, officer, committee member, or employee;'

(3) in paragraph (2) by striking 'any other person' the first time it appears and substituting in its place 'any agent or other person'; and

(4) 'in paragraph (2) by adding 'employee, agent; before' or other person' the last time it appears."

These amendments clarify that NCUA's prohibition authority extends to both employees and agents of federally-insured credit unions. The amendments conform the Agency's jurisdiction in prohibition actions with its jurisdiction in cease-and-desist actions.

o Section 206(g) of the Federal Credit Union Act (12 U.S.C. 1786(g)) is amended by adding paragraphs (7), (7)(A) and (7)(A)(i) to that subsection, which provides as follows:

"(7) Any person who, pursuant to this subsection, is removed, suspended, or prohibited from participation in the conduct of the affairs of an insured credit union

> shall also be removed, suspended, or prohibited from participation in the conduct of the affairs of any insured institution, any bank holding company or subsidiary of a bank holding company, any organization organized and operated under Section 25(a) of the Federal Reserve Act, or operating under Section 25 of the Federal Reserve Act, any savings and loan holding company or subsidiary of a savings and loan holding company (as those terms are defined in the National Housing Act), and any institution chartered by and subject to regulation by the Farm Credit Administration, without the prior written approval of the appropriate Federal regulatory agency."

(g)(7)(A) Definitions

> as used in subsection (g) -
>
> (i) The term "insured institution" means an insured credit union or a depository institution whose accounts are insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

This change would provide that if a person is removed, suspended, or prohibited from participation in the conduct of the affairs of an insured credit union, he is also removed, suspended or prohibited from all federally-insured depository institutions, all bank holding companies and all institutions chartered by the Farm Credit Administration (unless allowed back in by the appropriate Federal regulatory agency). This would eliminate the need for the OCC, FDIC or FSLIC or the Farm Credit Administration to take separate enforcement action against a person removed from a federally-insured credit union.

6. Clarification of NCUA Board's Authority to Liquidate Insolvent or Bankrupt Credit Unions.

Section 207(a)(1) of the Federal Credit Union Act (12 U.S.C. 1787(a)(1) is amended by adding subparagraphs (a)(1)(A) and (a)(1)(B) to that subsection, which provide as follows:

> (a)(1)(A) Not later than ten days after the date on which the Board closes a credit union for liquidation pursuant to subsection (a)(1), or accepts appointment as liquidating agent pursuant to subsection (b), such insured

> credit union may apply to the United States district court for the judicial district in which the principal office of such insured credit union is located or the United States District Court for the District of Columbia, for an order requiring the Board to show cause why it should not be prohibited from continuing such liquidation.
>
> (a)(1)(B) Except as otherwise provided in sub-paragraph (a)(1)(A), no court may take any action for or toward the removal of any liquidating agent or, except at the instance of the Board, restrain or affect the exercise of powers or functions of a liquidating agent.

Section 208(c) of the Federal Credit Union Act (12 U.S.C. 1788(c) is redesignated subsection (j) of Section 207 (12 U.S.C. 1787(j) and is amended by striking out in the last sentence: "subject to the regulation of the court or other public body having jurisdiction over the matter" and by inserting the following after the word "therewith" in the last sentence of paragraph (c) "subject only to the regulation of the Board, or, in cases where the Board has been appointed liquidating agent solely by a public authority having jurisdiction over the matter other than said Board, subject only to the regulation of such public authority."

These amendment clarify the Board's authority to act *ex parte* without notice in situations when the credit union is determined to be insolvent or bankrupt. As in Section 206 of the Federal Credit Union Act, the credit union has the ability to challenge the action within 10 days at a show cause hearing in district court. At such a hearing the Board would be required to establish that the statutory grounds for liquidation, (e.g., bankruptcy or insolvency) were present when it acted.

7. *Faithful Performance Elimination.*

"Section 112 of the Federal Credit Union Act (12 U.S.C. 1761a) is amended by striking out the third sentence and inserting in lieu thereof the following:

> 'The board shall elect from their number a financial officer who shall give adequate fidelity coverage in accordance with section 113(2) of the Act.'"

"Section 113 of the Federal Credit Union Act (12 U.S.C. 1761b) is amended by striking out paragraph (2) and inserting in lieu thereof the following:

> (2) provide adequate fidelity coverage for officers and employees having custody of or handling funds according to regulations issued by the Board.;"

Presently, the Federal Credit Union Act requires "Faithful Performance" coverage for financial officers at credit unions. This is coverage for negligence or, in effect, insuring the safety and soundness risks already insured by NCUSIF. The amendments would eliminate the faithful performance requirement. Basic fidelity coverages (e.g., fraud, dishonesty, embezzlement) would continue to be required for all officials and employees.

8. Avoid Balloon Payments.

Section 107(5)(A)(ii) of the Federal Credit Union Act (12 U.S.C. 1757(5)(A)(ii)) is amended by striking out everything after 'fifteen years' and inserting in lieu thereof 'or any longer term which the Board may allow;'"

This section is designed to help consumer/members with a dilemma sometimes occurring at the term completion of an adjustable-rate second mortgage or home improvement loan. Because of market interest rate fluctuations near the end of the loan, members can presently be confronted with either a balloon payment or higher monthly payments in order to completely pay the loan by the end of the present 15 year term. This amendment gives NCUA the authority to adjust the term of such loans to permit more leveling of the loan payout.

9. Negate "Transfer".

Title I of the Federal Credit Union Act is amended by adding at the end thereof the following:

> TRUST FUND
>
> "Sec. 129. Notwithstanding any other provision of law, all moneys of the Board shall be treated as trust funds for purposes of section 256(a)(2) of the Balanced Budget and Emergency Deficit Control Act of 1985. This section is effective for fiscal year 1986 and every fiscal year thereafter."

This amendment clarifies the status of NCUA's funds, thus negating the transfer of any such funds to OMB for fiscal year 1986 and each fiscal year thereafter.

10. Clarify Member Accounts.

"Section 107(6) of the Federal Credit Union Act (12 U.S.C. 1757(6)) is amended by inserting ', representing equity,' immediately after the word 'payments.'"

This amendment merely clarifies that shares, share certificates, and share drafts constitute a member's ownership interest in this credit union.

11. Technical Amendments.

o Membership Officer

"Section 113 of the Federal Credit Union Act (12 U.S.C. 1761b) is amended by striking out 'of the board of directors' in paragraph (1) and inserting in lieu thereof 'of the credit union.'"

Provides that membership officers may be selected from the credit union's membership rather than having only members of the board of directors eligible to be membership officers.

o Nonparticipation

Section 118 of the Federal Credit Union Act (12 U.S.C. 1764) is amended--

(1) by striking out 'subject to' in subsection (a) and inserting in lieu thereof 'except as provided in'; and

(2) by inserting 'and enforce' after 'adopt' in subsection (b)."

Technical amendment to clarify that paragraphs (a) and (b) of Section 118 of the Federal Credit Union Act are alternative methods of expelling a member of a credit union. There had been confusion as to whether (a) and (b) were alternatives or linked.

o "Change Section 107(7)(E) reference to 'section 848 of Title 31' to 'Section 9101 of Title 31.'"

Technical change necessary due to recodification of Title 31.

100th Congress
1st Session

H.R. _____

To amend the Federal Credit Union Act, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES
_______, 1987

A BILL

To amend the Federal Credit Union Act, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as follows: "Amendments to the Federal Credit Union Act, and other Acts pertaining to Federal Credit Unions."

TITLE I AMENDMENT TO THE GARN-ST GERMAIN ACT OF 1982

Sec. 101. Strike Section 141(a)(8) of Public Law 97-320. The provisions of Sections 131 and 132 of P.L. 97-320 are in full and continuing effect upon enactment of this section.

TITLE II AMENDMENTS OF THE FEDERAL CREDIT UNION ACT

Sec. 201. Amend Section 206(h)(2)(B) of the Federal Credit Union Act (12 U.S.C. 1786(h)(2)(B)) by striking the word 'ninety' and inserting in lieu thereof the word 'thirty.'

Amend Section 206(h)(1) of the Federal Credit Union Act by deleting the "or" at the end of subparagraph (A), deleting the "." at the end of subparagraph (B) and inserting a "," in lieu thereof and by adding the following:

(C) there is a willful violation of a cease and desist order which has become final; or

> (D) there is concealment of books, papers, records, or assets of the credit union or refusal to submit books, papers, records, or affairs of the credit union for inspection to any examiner or to any lawful agent of the Board.

Amend Section 206(h)(2(B) of the Federal Credit Union Act by adding the following new subsection (8), and by renumbering the present subsection (8) as (9).

> The conservator shall have all the powers of the members, the directors, the officers, and committees of the credit union and shall be authorized to operate the credit union in its own name or to conserve its assets in the manner and to the extent authorized by the Board.

Sec. 202. Amend Section 120(i)(1) of the Federal Credit Union Act (12 U.S.C. 1766(i)(1) by inserting after 'personnel,' the language 'without regard to the provisions of other laws applicable to officers or employees of the United States,' and by inserting after 'functions,' the language 'and determine their compensation, leave, and expenses, governed solely by the provisions of this Act and the rules and regulations of the Board not inconsistent therewith;'

Sec. 203. Amend Section 120(i)(2) of the Federal Credit Union Act (12 U.S.C. 1766 (i)(2)) by inserting after 'reimbursement,' the language 'acquire and dispose of, by lease or purchase, real or personal property, without regard to the provisions of any other law applicable to executive or independent agencies of the United States,' and by inserting after the word 'Act" a comma (",") and adding the language 'in accordance with the Rules and Regulations or polices established by the Board not inconsistent with this Act;'

Sec. 204 Amend Section 206(g) of the Federal Credit Union Act (12 U.S.C. 1786(g)) as follows:

> (1) in paragraph (1) by striking 'director, officer, or committee member' each time it appears and substituting in its place 'director, officer, committee member, or employee;'
>
> (2) in paragraph (2) by striking 'director, officer or committee member' the first two times it appears and substituting in its place 'director, officer committee member, or employee;'

(3) in paragraph (2) by striking 'any other person' the first time it appears and substituting in its place 'any agent or other person;' and

(4) in paragraph (2) by adding 'employee, agent' before 'or other person' the last time it appears.

Amend Section 206(g) of the Federal Credit Union Act (12 U.S.C. 1786(g)) by adding paragraph (7), (7)(A) and (7)(A)(i) to that subsection, which provides as follows:

"(7) Any person who, pursuant to this subsection, is removed, suspended, or prohibited from participation in the conduct of the affairs of an insured credit union shall also be removed, suspended, or prohibited from participation in the conduct of the affairs of any insured institution, any bank holding company or subsidiary of a bank holding company, any organization organized and operated under Section 25(a) of the Federal Reserve Act or operating under Section 25 of the Federal Reserve Act, and any savings and loan holding company or subsidiary of a savings and loan holding company (as those terms are defined in the National Housing Act), and any institution chartered by and subject to regulation by the Farm Credit Administration without the prior written approval of the appropriate Federal regulatory agency."

(g)(7)(A) Definitions

as used in subsection (g) -

(i) The term "insured institution" means an insured credit union or a depository institution whose accounts are insured by the Federal Deposit Insurance Coproration or the Federal Savings and Loan Insurance Corporation.

Sec. 205 Amend Section 207(a)(1) of the Federal Credit Union Act (12 U.S.C. 1787(a)(1) by adding subparagraphs (a)(1)(A) and (a)(1)(B) to that subsection, which provide as follows:

(a)(1)(A) Not later than ten days after the date on which the Board closes a credit union for liquidation pursuant to subsection (a)(1), or accepts appointment as liquidating agent pursuant to subsection (b), such insured credit union may apply to the United States district court for the judicial district in which the principal office of such insured credit union is located or the United States District Court for the District of Columbia, for an order requiring the Board to show cause why it should not be prohibited from continuing such liquidation.

(a)(1)(B) Except as otherwise provided in sub-paragraph (a)(1)(A), no court may take any action for or toward the removal of any liquidating agent or, except at the instance of the Board, restrain or affect the exercise of powers or functions of a liquidating agent.

Section 208(c) of the Federal Credit Union Act (12 U.S.C. 1788(c) is redesignated subsection (j) of Section 207 (12 U.S.C. 1787(j) and is amended by striking out in the last sentence: "subject to the regulation of the court or other public body having jurisdiction over the matter" and by inserting the following after the word "therewith" in the last sentence of paragraph (c) "subject only to the regulation of the Board, or, in cases where the Board has been appointed liquidating agent solely by a public authority having jurisdiction over the matter other than said Board, subject only to the regulation of such public authority."

Sec. 206 Amend Section 112 of the Federal Credit Union Act (12 U.S.C. 1761a) by striking out the third sentence and inserting in lieu thereof the following:

> The board shall elect from their number a financial officer who shall give adequate fidelity coverage in accordance with section 113(2) of the Act.

Amend Section 113 of the Federal Credit Union Act (12 U.S.C. 1761b) by striking out paragraph (2) and inserting in lieu thereof the following:

> (2) provide adequate fidelity coverage for officers and employees having custody of or handling funds according to regulations issued by the Board.;

Sec. 207 Amend Section 107(5)(A)(ii) of the Federal Credit Union Act (12 U.S.C. 1757(5)(A)(ii) by striking out everything after 'fifteen years' and inserting in lieu thereof 'or any longer term which the Board may allow;'

Sec. 208 Amend Title I of the Federal Credit Union Act by adding at the end thereof the following:

TRUST FUND

> "Sec. 129. Notwithstanding any other provision of law, all moneys of the Board shall be treated as trust funds for purposes of section 256(a)(2) of the Balanced Budget and Emergency Deficit Control Act of 1985. This section is effective for fiscal year 1986 and every fiscal year thereafter."

Sec. 209 Amend Section 107(6) of the Federal Credit Union Act (12 U.S.C. 1757(6)) by inserting, 'representing equity,' immediately after the word 'payments.'

Sec. 210 Amend Section 113 of the Federal Credit Union Act (12 U.S.C. 1761b) by striking out 'of the board of directors' in paragraph (1) and inserting in lieu thereof 'of the credit union.'

Amend Section 118 of the Federal Credit Union Act (12 U.S.C. 1764)

(1) by striking out 'subject to' in subsection (a) and inserting in lieu thereof 'except as provided in;'

(2) by inserting 'and enforce' after 'adopt' in subsection (b); and

by changing the Section 107(7)(E) reference of the Federal Credit Union Act to 'section 846 of Title 31' to 'Section 9101 of Title 31.'

"AMENDMENTS TO THE FEDERAL CREDIT UNION ACT, AND OTHER ACTS PERTAINING TO FEDERAL CREDIT UNIONS"

SECTION 1. This section cites the title of the Act.

TITLE I AMENDMENT TO THE GARN-ST GERMAIN ACT OF 1982

Section 101.

This section eliminates the sunset provisions from the National Credit Union Administration's (NCUA's) conservatorship and emergency merger authorities. During its four year "trial period," conservatorship has proven to be an effective supervisory tool for NCUA. Through the prudent exercise of its conservatorship authority, more than $43 million in potential losses to the National Credit Union Share Insurance Fund (NCUSIF) have been avoided. This section removes the sunset provision, rendering the conservatorship authority permanent. This section also states that Sections 131 and 132 of P.L. 97-320 are in full and continuing effect upon enactment of this section.

TITLE II AMENDMENTS TO THE FEDERAL CREDIT UNION ACT.

Section 201.

This section reduces from ninety days to thirty days the period NCUA must allow state regulators to respond to NCUA's proposed imposition of conservatorship in the case of a state-chartered NCUA insured credit union. Events today often compel quicker and more decisive action by regulators such as NCUA than the ninety day consultation period allows;

Provides NCUA with two additional grounds for imposing conservatorship: when there is a willful violation of a cease-and-desist order which has become final; and, when there is a concealment of or refusal to submit documents and/or other records of the credit union to an NCUA examiner or other lawful agent of the NCUA Board; and

Expressly states that NCUA has all the power of the credit union members, directors, officers, and committees when exercising its conservatorship authority.

Section 202.

This section clarifies NCUA's status as an independent agency by granting NCUA independence from the Office of Personnel Management (OPM) with respect to areas such as selection and placement of employees and the provision of job-related benefits. Such authority would allow NCUA the flexibility to attract and retain qualified examiners and employees in a competitive marketplace.

Section 203.

This section is designed to provide the NCUA Board with needed flexibility to obtain office space and equipment in such a manner as to respond more precisely to the nature and location of the agency's needs at substantial cost savings.

Section 204.

This section clarifies that NCUA's prohibition authority extends to both employees and agents of federally-insured credit unions, and conforms NCUA's jurisdiction in prohibition actions with its jurisdiction in cease-and-desist actions; and

Provides that if a person is removed, suspended or prohibited from participation in the conduct of the affairs of an insured credit union, he is also removed, suspended or prohibited from all federally-insured depository institutions and all bank holding companies and all institutions chartered by the Farm Credit Administration (unless allowed back in by the appropriate agency). This would eliminate the need for the OCC, FDIC or FSLIC to take separate enforcement action against a person removed from a federally-insured credit union.

Section 205.

This section clarifies the Board's authority to act *ex parte* without notice in situations when the credit union *is* determined to be insolvent or bankrupt. As in Section 206 of the Federal Credit Union Act, the credit union has the ability to challenge the action within 10 days at a show cause hearing in district court. At such a hearing the Board would be required to establish that the statutory grounds for liquidation (e.g., bankruptcy or insolvency) were present when it acted.

Section 206.

This section would eliminate the requirement found in present law that Federal credit unions obtain "faithful performance" coverage for financial officers. Basic fidelity coverages (e.g., fraud, dishonesty, embezzlement) would continue to be required for all officials and employees.

Section 207.

This section is designed to help consumer/members with a dilemma sometimes occurring at the term completion of an adjustable-rate second mortgage or home improvement loan. Because of market interest rate fluctuations near the end of the loan, members are presently be confronted with either a balloon payment or higher monthly payments in order to completely pay the loan by the end of the present 15 year term. This section gives NCUA the authority to adjust the term of such loans to permit more leveling of the loan payout.

Section 208.

This section clarifies the status of NCUA's funds, thus negating the transfer of any such funds to OMB. This section would be effective for fiscal year 1988 and each fiscal year thereafter.

Section 209.

This section clarifies that funds in shares, share certificates, and share draft accounts constitute a member's ownership interest in the credit union.

Section 210.

This section provides that membership officers may be selected from the credit union's membership, rather than having only members of the board of directors eligible to be membership officers;

Contains a technical amendment to clarify that paragraphs (a) and (b) of Section 118 of the Federal Credit Union Act are alternative methods of expelling a member of a credit union. There had been confusion as to whether (a) and (b) were alternative or linked. A credit union may either adopt its own policy for expulsion, as set forth in paragraph (b), or it may simply expel a member under the terms of paragraph (a) if the credit union hs not adopted its own policy under paragraph (b); and

Provides a technical change made necessary due to the recodification of Title 31 of the United States Code.

STATEMENT BY
SEARS, ROEBUCK AND CO.

FOR THE RECORD

IN CONNECTION WITH THE OVERSIGHT HEARINGS

ON BANKING LEGISLATION

BEFORE THE COMMITTEE ON BANKING,

HOUSING AND URBAN AFFAIRS

OF THE UNITED STATES SENATE

JANUARY 21 - 23, 1987

It is by now a truism that we are in a period of great change in banking and other financial services. Many would like to stop that change and return to the structures of the past. But there is no reason to think that the nation will do that nor that it would be advantageous if we did. It is more useful to attempt to shape the direction of change by identifying problems that exist in the financial services marketplace and try to address them in a way that benefits as many people as possible.

Diversified companies, such as Sears, want to engage in some forms of banking. Consumers, understandably, want improved guarantees of safety and improved service. We believe the goals of Sears, and similar companies, and those of consumers are compatible.

Virtually all consumers need access to some form of basic banking services, but many don't have that access because fees for services or minimum balance requirements have increased rapidly since deposit interest rates were deregulated.

Diversified companies, such as Sears, would like to enter or remain in the consumer banking business because we believe that we can safely offer services that are desired by consumers and, by doing so, make a profit for our shareholders.

The public seems more and more comfortable with the notion of doing banking business with non-traditional banks. A recent American Banker survey showed that the number of people who would like to do their banking at a non-traditional institution rose from 10 percent two years ago to 20 percent today.

In contrast, there are those who are opposed to diversified companies offering banking services. This includes many banks.

We believe that they must bear the burden of proof that diversified companies should not be in banking. In our market economy, the general assumption has been, and should be, that entry into a business should not be prohibited -- and competition thus restricted -- unless it can be clearly shown that it would create an unavoidable and intolerable threat to the public interest.

Opening the banking markets to new consumer oriented competitors, who are regulated to assure safety and soundness and required to offer a high level of service, has much merit. Consumers should be able to demand that companies that receive certain benefits from the Government -- for example, access to the Federal Reserve window and the deposit insurance system -- be required to operate in a manner that meets certain basic public needs.

The propriety of Sears ownership of banks should be judged on our ability and willingness to meet the tests of safety and service.

Sears presently owns what are known as nonbank banks, or limited service banks. One of these banks -- Greenwood Trust Co. of Delaware -- is the issuer of the Discover Card. A limited service bank is an institution that is insured and regulated and subject to all of the same laws as any commercial bank, with one exception. By either not offering demand deposits or making commercial loans, a limited service bank is not prohibited from being owned by a diversified company. In every other respect, however, a limited service bank is regulated and insured in the same way as any other bank.

We would prefer not to continue to operate these banks in an uncertain legislative climate. This climate undoubtedly deters many effective new competitors. We have, therefore, proposed to Congress that they authorize the creation of a new type of limited service bank that would forego commercial loans and provide service only to individuals. Those institutions — consumer banks -- could be owned by diversified companies such as Sears.

Consumers have a right to demand that such banks be sound, meet community needs and provide excellent service at competitive prices.

Consumer banks will be safe. They will be regulated and insured and subject to all of the laws and regulations on commercial banks, including consumer protection measures such as Fair Credit, Fair Housing, Community Reinvestment and state and federal usery laws.

In fact, consumer banks may be safer than many commercial banks because they will make only consumer loans. Consumer loans are spread over larger numbers of people in smaller amounts than commercial loans. A bank that makes only consumer loans doesn't run the risk of large loans to foreign governments or oil speculators that can undermine the safety of the bank.

A related concern is that consumer banks would take deposits away from local banks and result in their closing. Independent studies show that this is not a threat. States with open branching or holding companies have not shown a pattern of losing small institutions. This argument was also used against interstate banking, but it lost its force in the face of the evidence.

Some people have been concerned about the possibility of tie-ins. A special problem has been credit life insurance offered by lenders. Some are concerned that a bank owned by a diversified company will, for example, require consumers to purchase real estate or homeowner's insurance from a related company as a condition of receiving a loan.

These actions are against the law for most banks now. But we have gone further and have urged that legislation creating consumer banks should specifically prohibit tie-ins. We believe that effective laws and regulations can be designed to minimize this illegal practice.

As these points demonstrate, consumer banks are not a threat to the public welfare. Indeed, they can provide services that are missing. Consumers want access to basic banking, faster check clearing, truth-in-savings and other similar services.

Consumer groups and individual consumers have urged that some type of basic banking service should be available to consumers. We have proposed that consumer banks be required to offer free checking on non-interest bearing accounts with no minimum balance.

Consumer banks would be prohibited from making loans to their parent companies, from upstreaming or cross-streaming funds to affiliated companies. Present banking law contains severe restrictions on such loans. Sears has suggested that consumer banks be placed under even more rigid restrictions. Further, any loan to the parent company or another subsidiary would be a commercial loan and, by definition, prohibited.

Such prohibitions on loans to affiliates minimize the risk that, if the parent company gets into trouble, the bank might be used to shore it up.

Consumer banks would be good for the community. Some people have expressed concern that, unless local control of banks is assured, local money might be channeled out of a community and sent to major metropolitan areas to finance construction and other projects. This argument was used against interstate banking, but a majority of states have now opened their doors to out of state banks with few or no requirements for reinvesting in the state. Moreover, consumer banks couldn't finance construction of high rise buildings or any other commercial project, because those banks wouldn't be allowed to make commercial loans.

Sears is a countrywide business. We have no desire to send all of our funds to Chicago, and it would make no business sense for any company to do something similar. Nevertheless, we have proposed that consumer banks be required to reinvest 65 percent of the funds raised from local depositors in the bank's home state. No locally owned bank is presently subject to such a high standard for reinvestment.

Consumer banks would be required to comply with truth-in-savings -- uniform disclosures on interest rates and other terms affecting deposit accounts.

Consumer banks would be required to give prompt credit on checks deposited with them.

There are other advantages. Cross selling may be one. There is no reason not to offer information and discounts to customers. Cross selling is very different from tie-ins -- because tie-ins coerce the customer into accepting something he or she doesn't need or want, or at a noncompetitive price. Cross selling, on the other hand, is a consumer benefit.

Some people have argued that all banks, not just consumer banks, should be required to provide these services. We won't argue against that. But why not start with companies which want to provide the services customers need? If they are required to provide these services, other banks may well feel they have to match them.

There is little to lose and much to gain by supporting consumer banks. Sears wants to serve consumers through such banks. We think that we have answered the charges made by opponents of consumer banks and that our proposal merits the consideration and support of Congress.

RANDOLF H. AIRES
VICE PRESIDENT

Sears, Roebuck and Co.
February 9, 1987